

CHAPTER

AZERBAIJAN: COUNTRY REVIEW

TWO

SUMMARY

The global economic boom of 2000-08 and the steep rises in petroleum prices resulted in very rapid growth for Azerbaijan. Prior to the 2008/09 downturn, GDP grew at over 20% per year, reflected in sharp increases in fiscal revenues. In consequence, and in order to support the further expansion of the oil industry, there was a high rate of both public and private investment in oil-industry-linked infrastructure investment, particularly around the Caspian Sea and the capital, Baku. These investments created a large number of new jobs and led to a significant decline in the rates of extreme poverty. State revenues also allowed the government to make progress on the Millennium Development Goals (MDGs) of the United Nations and further social progress is within reach.

The dependence on oil and petroleum-related industries presents challenges for Azerbaijan. According to various estimates, oil reserves could be exhausted in a relatively short time span. Hence, it is urgent to develop other sectors of the economy, especially agriculture, services and non-oil industries. With this perspective, small and medium-sized enterprises (SMEs), and the private sector in general, need support in the form of opening up of opportunities for investors, access to finance for SMEs, reform of the education system to match the needs of the economy with the output of institutes of learning and reform and modernisation of health services to enhance the quality of life of the population.

Reforms are underway to underpin competitiveness and bring market regulations into line with international standards. More needs to be done, however, to support SMEs, which are the basis of diversified growth. While reforms in the health and social services have been significant, the quality of health care remains below internationally acceptable targets. Finally, the country remains handicapped by the still-unresolved conflict with neighbouring Armenia and coping with a million displaced persons.

The report identifies main challenges and provides recommendations on measures to be strengthened in order to overcome the negative impact of the global economic crisis and achieve sustainable economic growth:

- shift production to support the non-oil sector;
- develop comprehensive investment promotion strategies;
- ensure transparency in business regulation and licensing procedures.

INTRODUCTION

Since 1996, Azerbaijan has experienced macroeconomic stability and dynamic economic development. A number of significant policies, to be developed further, have been implemented to promote socio-economic development, with a high priority on oil strategy with the development of the Caspian energy resources. Since the "Contract of the Century"¹, signed in 1994 between the State Oil Company of Azerbaijan Republic (SOCAR) and the Western Oil Consortium to develop Azerbaijan's Caspian oil reserves (Azeri-Chirag-Gunashli), the level of foreign and domestic investment in Azerbaijan from 2004 to 2009 amounted to USD 70 billion, half of which was foreign investments. Macroeconomic stability was therefore achieved as a result of the entrance of oil giants in the domestic market. Processes to create acceptable economic infrastructure and adopt new laws regulating the business environment were initiated as early as in 1993, under former President Heydar Aliyev.

Despite the positive macroeconomic results, there are still a number of problems to be tackled, especially the improvement of the economic and social situation of the population, fairer distribution of incomes, the reduction of unemployment and the diversification of the economy.

The economy of Azerbaijan, in many respects, still depends on the extraction of hydrocarbons. With the growing volumes of receipts from oil exports and the inadequacy of monetary instruments available to the government, controlling inflation and excessive evaluation of the national currency have become major problems.

Azerbaijan's dependence on the oil sector leads to fears of Dutch Disease: negative economic consequences arising from natural-resource price increases with a negative effect on industrial and manufacturing development. Moreover, forecasts led by British Petroleum and SOCAR have shown the peak of extraction of these resources in Azerbaijan to be reached in 2014 (OECD/IEA, 2010), leading to the exhaustion of possibilities of extensive growth. In parallel, the global economic recession of 2008-09 emphasises vulnerability to international energy shocks, in a country where more than 90% of all exports are oil-related, raising issues of diversification and the development of non-oil sectors. Hence, it is necessary now to involve new resources for steady economic growth, such as processing industries.

RECENT ECONOMIC DEVELOPMENTS

Azerbaijan's economy has fundamentally changed since 2006, when oil started to be dispatched through the Baku-Tbilisi-Ceyhan (BTC) pipeline, as a new phase of development was implemented and oil revenues began to flow.

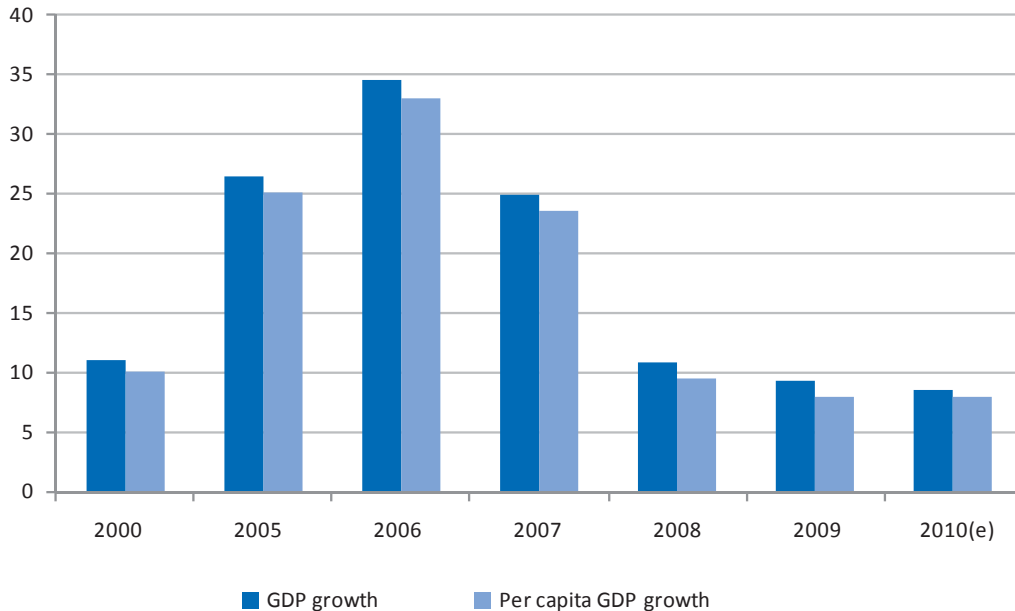
Industry, construction and services showed strong turnover and wages growth. Foreign currency inflows (US dollar) boosted the state budget and fuelled inflation – which averaged 18% in 2007-08. The role of the state oil fund, SOFAZ, during this period allowed a tight control of revenues and expenditures in the oil sector, which prevented Dutch Disease.

The rise in oil prices allowed the government to engage in large-scale infrastructure projects to pave the way for the non-oil sectors; a real challenge for the country's future development. The government has engaged in important modernisation of social services programmes mostly since 2000, which have played a vital role in reducing poverty. The major expenditures of SOFAZ being transfers to the state budget (50% of budget revenues), the government was able to increase pensions and wages and to invest in schools, universities and hospitals. Consequently, poverty decreased significantly from 49% to 11.2% between 2001 and 2009. The national poverty line indicator increased by 3.7 times from 24 Azerbaijani manat (AZN) to AZN 89.5 over the same period.

Although the country managed to record positive growth in 2009, nearly all macroeconomic indicators were affected by the global downturn. For the first time, the country was forced to increase production for less profit, which is a distinctive feature of raw materials exporting countries. If the crisis had not taken place, annual nominal GDP was forecast to increase by an additional AZN 4 billion in 2009. The reduction of the nominal GDP to AZN 34.6 billion was caused by falling oil prices and moderate rates of the non-oil sector development. Indeed, the oil sector contributed to a rise of 14.3% of GDP, while the non-oil sector of only 3.2%.

Azerbaijan returned to high growth in the second half of 2009 with an increasing oil price. Therefore, the country's GDP increased by 9.3%, while forecasts done by the IMF for 2010 and 2011 show growth of 7.5% and 4.1% respectively, the highest in the Black Sea region. GDP per capita grew by 7.9% in 2009, amounting to AZN 3 917.3, before decreasing to AZN 2 539.9 in January-November 2010. According to the International Monetary Fund (IMF), per capita GDP in parity purchase power (PPP) terms for 2000-08 increased by 3.9 times and reached the level of USD 8 600 which is very high for a transition country (IMF, 2009). As a consequence, the end of the "transition period" was officially announced by President Ilham Aliyev in the first quarter of 2010.

Figure 2.1. Real GDP and per capita GDP growth rate
(annual percentage change)

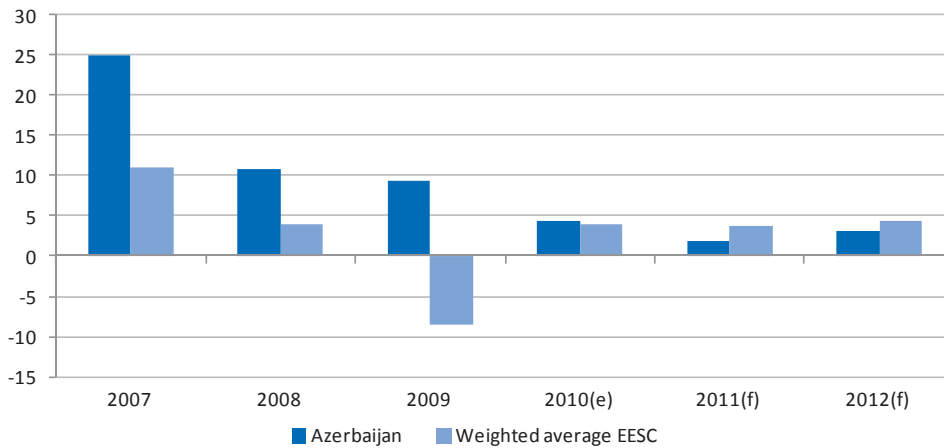


Source: The State Statistical Committee of Azerbaijan.

It is interesting to note that real GDP has grown at a faster rate than the per capita GDP. This is due to a constant increase of the population since 2000 with the return of the economic boom in Azerbaijan.

Azerbaijan showed better economic performance in 2000-10 than any of the other EESC countries² by increasing its GDP from AZN 4.7 billion in 2000 to AZN 36.7 billion in 2010.

Figure 2.2. Real growth rate in Azerbaijan
(annual percentage change)



Source: IMF WEO, October 2009.

General overview

In 2010, Azerbaijan's gross domestic product (GDP) growth reached 4.3%, compared to 9.3% in 2009; in current prices, GDP growth in 2010 totalled 6%. The country is relatively less integrated in the world economy and was not affected as severely by the international crisis as were other Eastern Europe and South Caucasus (EESC) countries like Ukraine, for example, with a contraction of 15%. The government's support to banks and continuous commitments to infrastructure projects also mitigated the impact of the crisis. Nonetheless, the drop in oil returns in the first half of 2009 highlighted Azerbaijan's vulnerability to energy shocks and the commodity exports dependency risk. In 2009, some sectors, such as construction and metallurgy, acknowledged serious difficulties. Despite that, nearly all sectors registered growth. Moreover, 45.5% of production occurred in the non-oil sector, with growth of 3.2%. In 2010, the non-oil sector made up 42.4% of total GDP, an annual increase of nearly 6% in value.

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Figure 2.3. Share of non-oil sector in GDP

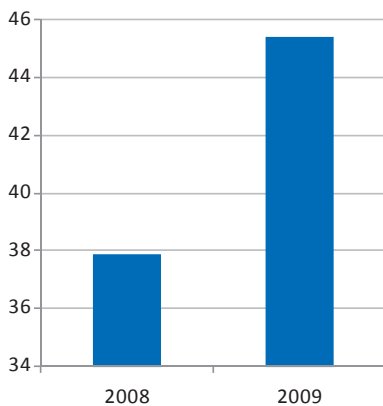
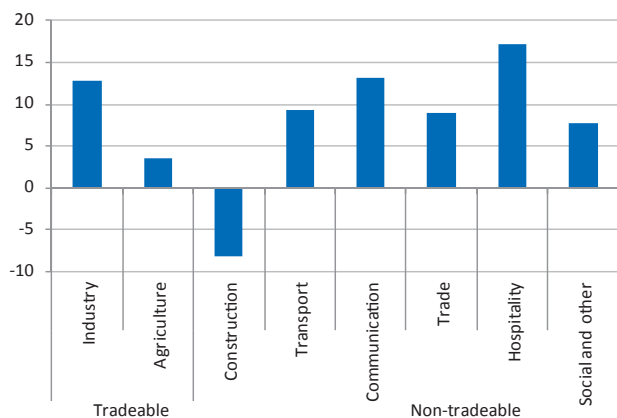


Figure 2.4. Real economic growth rates in 2009, by sector (percentage)



Source: The State Statistical Committee of Azerbaijan Republic.

According to the State Statistical Committee of Azerbaijan, quarterly GDP increased by 5.4% in the first quarter of 2010 compared to the first quarter of 2009, amounting to AZN 9.5 billion. Quarterly GDP peaked at AZN 10.6 billion in Q2 2010 before declining to its Q1 2010 level in the third quarter.

Inflation

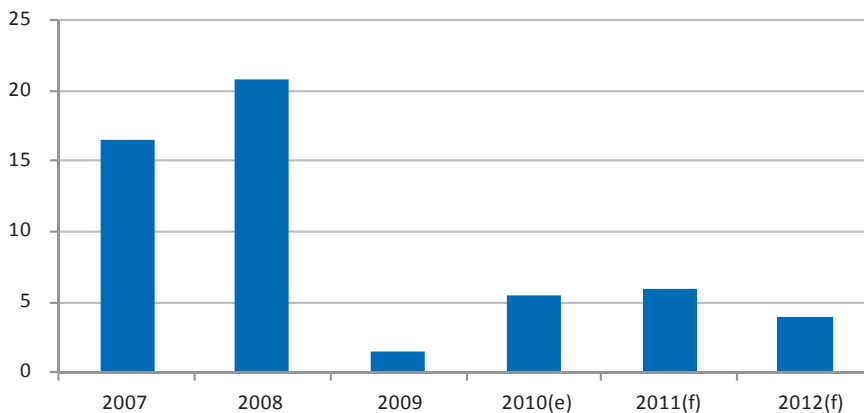
Azerbaijan succeeded in reducing inflation to a single digit between 2000 and 2006. Indeed, the Central Bank performed well over these years, keeping money supply and inflation under strict control until 2007 and 2008, when it recorded inflation rates of 16.7% and 20.8% respectively. According to the State Statistical Committee of Azerbaijan, the price adjustment in 2000 between nominal and real GDP was 112.5%, reduced to 78.8% in 2009. External (import-cost push) as well as internal (growth of wages, income and employment) factors led to the increase of consumer goods prices.

These factors have also been backed by a huge increase in expenses of the state budget and a strong increase in monetary aggregates (that expanded several times), which have raised expectations since 2005.

The state monopoly also led to an increase in tariffs of electricity, gas and petrol³ since 2007, causing a supply shock in the economy with a multiplicative effect on the services sphere. Besides, inflation usually leads to decreased investment, which reduces the speed of economic growth with a negative effect on poverty, since lower incomes become vulnerable. Therefore protecting the poor from inflation pressure remains an important issue for Azerbaijan.

The purchasing power of the population showed two-digit growth against one digit in agriculture, implying excess of demand over food supply, which can be explained by the exhaustion of current agricultural capacity and lack of development in agriculture.

Figure 2.5. Inflation, average consumer prices

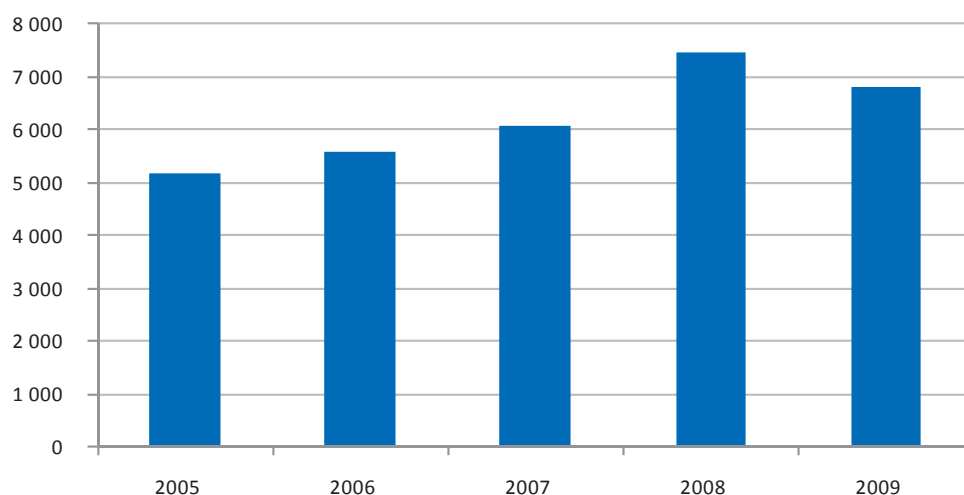


Source: IMF WEO, October 2009.

On the other hand, inflation in Azerbaijan is mostly demand-driven, which, at moderate levels, can increase investment in the national economy by absorbing excessive supply.

Oil fields, along with pipeline construction, have generated a significant amount of both domestic and foreign direct investment (FDI) in the country. The volume of investments in the oil and gas sector of Azerbaijan has exceeded USD 38 billion of which more than USD 20 billion have been directed to studies of the subsoil area of "Azeri-Chirag-Guneshli" (ACG), a large complex of oil fields in the Caspian Sea, where 850 000 barrels of oil are extracted daily.

Figure 2.6. Gross fixed capital formation (new investments)
(AZN million)



Source: The State Statistical Committee of Azerbaijan Republic.

Analysis by account

Consumption

As a result of rapid economic growth, nominal incomes of the population increased by 20.5%, from AZN 4 billion in 2000 to AZN 22.7 billion in 2010, which is three times higher than average inflation (7.2%) in the same period. In 2009, 58% of income structure came from wages and entrepreneurial income; agricultural activities and pensions/social facilities accounted for 15.3% and 15.7% respectively.

Positively impacted by household revenue growth, total real household consumption rose from AZN 3 billion in 2000 to AZN 14.8 billion in 2009 (4.9 times). Its share in GDP decreased from 63% to 42.8% over this period. Unlike in previous years, consumption was the major source of economic growth in 2009, while between 2006 and 2008 it was trade which dominated aggregate demand.

Consequently, the share of food in households' expenditure decreased between 2002 and 2009, from 64% to 51% for the urban population and from 74% to 56% for rural households, thus increasing the share of non-food consumption goods.

Table 2.1. Monthly expenditure evolution between 2002 and 2009

Total expenditure:	2002	2009
Average monthly total expenditure per household (AZN)	46.2	129.6
Share of food (% of total expenses)	53.6	52.9
Share of manufactured goods and services (%)	37.0	34.5
Share of non-consumption expenditures (%)	9.4	12.6
Loan to deposit ratio*	109.0	177.0

Note: *Annualised, author's estimation.

Source: The State Statistical Committee.

*Source: the Central Bank of Azerbaijan Republic, author's calculations.

Monthly per capita income grew at a faster pace than per capita expenditure between 2006 and 2008. Indeed, average monthly expenditure grew 2.8 times from 2002 to 2009.

Average monthly wages grew considerably from AZN 44.3 in 2000 to AZN 298 in 2009, a 23% annual increase, which was also more than average inflation over the same period. However, these average indicators do not display an accurate picture of the situation, since there is a ten-fold difference between salaries in the mining industry, leader of the economy, and in agriculture, which is the lowest-paid sector. The financial sector, real estate and rents are also high while education, health and social services share the lower pay scales.

Consumption was also supported by persistent access to bank loans, which increased from AZN 0.04 billion in 2000 to AZN 2.33 billion in 2009. Household loans' share in total credits increased from 8.9% in 2000 to 35.4% in 2007 (which increased expenditure to manufactured and non-consumption goods and services), then decreased to 27.7% in 2009, due to the crisis and tougher lending rules, consequently hindering the process of stimulating aggregate demand.

Government expenditures and revenues

In 2005-09, due to the oil boom, the government implemented policies to improve living standards and upgrade and expand critical infrastructure. Current expenditure increased by a cumulative 6.2 times in nominal terms from 2000 to 2009 (7% and 13% of total consumption respectively), while total consumption increased from AZN 3.8 billion to AZN 19.4 billion over the same period.

Public consumption is of goods and services purchased from the state budget; 32.4% of the budget was composed of wages, pensions and purchases of goods and services, up by 8.6% in 2009 compared to 2008. Public expenditure increased from AZN 0.7 billion to AZN 4.4 billion between 2000 and 2009, a steady share of GDP of 12% on average.

Table 2.2. Evolution of government debt, revenue and support

Debt, taxes and budget support	2000	2009
Short-term debt (% of external debt sources)	11.8	34*
Debt (% of GDP)	25.6	7.9
Total debt service (as % export of goods, services and income)	5.8	1.0
General government final consumption expenditure (% of GDP)	15.2	12.9
Tax revenues (% of GDP)	14.5	16.2
Net official development assistance – ODA (USD million) and official aid – OA (USD million)	139.0	235.0**

Notes: *2007, **2008.

Sources: The State Statistical Committee, OECD, World Bank WDI.

Government borrowing rose from USD 1.3 billion in 2002 to USD 3.4 billion in 2009, while its correlation to GDP decreased substantially from 22% to 8% over the same period, thanks to the huge increase of GDP. Per capita debt increased from USD 159 to USD 380 between 2002 and 2009. Approximately 90% of external resources went to investment. Investment in the power supply sector took about 40% of total FDI, 3.7% was on agricultural development and highway engineering, the transport sector accounted for 25%, systems of water supply and land reclamation took 9% and the oil and gas sector, along with the chemical industry, took up 6% of foreign financings.

Government spending from the state budget in the social sphere⁴ doubled, from AZN 1.7 billion in 2007 to AZN 2.9 billion in 2009. Its average growth rate reached 30% (without the economic crisis, it was expected to reach an average of 45%), while accounting for 6.5% of GDP, its share in the state budget was 25% over the same period. Despite this serious growth in social spending, its budget share and share of GDP, health and social security expenditures in particular, are below levels in developed economies. Moreover, these expenditures are mostly directed to fixed needs of the social sphere rather than enhancing human capital.

Investments

Investments in fixed capital increased from AZN 0.968 billion in 2000 to AZN 9.9 billion in 2008, only to decline to AZN 7.7 billion (22.3% of GDP) in 2009. In November 2010, capital investments totalled AZN 7.7 billion (USD 9.6 billion). As much as 73.4% of total gross investment (AZN 5.7 billion) was directed towards the non-oil sector in 2009 against 34.9% (AZN 2.0 billion) in 2005. The share of foreign investment in total investments decreased from 68.7% in 2005 (USD 4.8 billion) to 42.7% in 2009 (USD 5.5 billion).

International organisations and countries such as the United Kingdom, the United States of America, Japan, France, Norway, Czech Republic and Turkey had a total share of 87.3% (AZN 1.3 billion) of foreign investment in 2009; the United Kingdom's accounting for 51% of total investments (AZN 0.7 billion) that year. Moreover, on 16 August 2010, British Petroleum (BP) bought the shares of Devon Energy Corporation (the largest American independent oil and gas company) in the Azerbaijani oil and gas project ACG, a transaction worth USD 2 billion.

FDI to the country has been largely directed to the oil sector. Although there are numerous opportunities for foreign investors in fields such as agriculture and services, little FDI reached beyond the oil sector. Foreign investments in the non-oil sector are concentrated in construction, telecommunications and services. The industrial sector and agricultural processing have also attracted foreign investment in recent years. The slow pace of privatisation of public utilities has restricted the levels of FDI to the sector. The economic crisis also affected FDI inflows despite the government's efforts in infrastructure and overall business improvement.

Trade

Azerbaijan's export value was multiplied by 11.5 between 2000 and 2010 (from USD 1.9 billion to USD 21.8 billion), and imports by 5 (from USD 1.5 billion to USD 6.5 billion). The increase is due to the execution of large projects in the oil and infrastructure sectors. Analysis of the balance of payments shows that external trade operations in the oil and gas sector have been positive, but negative in non-oil sectors. Receipts in the oil and gas sector mainly come from the export of oil and inflow of foreign capital, while expenditure consists of capital repatriation and equipment imports.

The economic crisis led exports and imports to reduce sharply from USD 30.6 billion (31.0%) and from USD 7.6 billion (14.0%) respectively between 2008 and 2009. The trade balance decreased by 36.5% from USD 23 billion over this period.

Overall, the country's trade balance increased by 51 times in 2010 reaching USD 15.3 billion, from USD 0.3 billion in 2000. This growth was mainly due to the price and production increase in oil.

Table 2.3. Current account balance

	2005	2006	2007	2008	2009	2010*	2011**	2012**
Current account balance (USD billion)	0.2	3.7	9.0	16.4	10.2	13.1	13.1	13.3
Current account balance (% GDP)	1.3	17.6	28.8	35.5	23.6	25.3	24.2	23.5

Notes: *Expected, **Forecast.

Source: IMF WEO 2010.

Azerbaijan sold commodities to around 140 countries in 2009. Foreign trade with CIS countries accounted for 10.4% of the total foreign trade. Trade relationships with Italy, the United States, France, Israel, Turkey, Russia, Chinese Taipei, Indonesia, Canada and the United Kingdom represent 69.8% of total trade. Exports of goods are more than 90% composed of oil while imports are more diversified with civil engineering, equipment and motor vehicles.

Informal economy⁵

Local estimates of the share of informal economy in total GDP vary between 5% and 10% of GDP. According to Schneider (2010), the informal sector in Azerbaijan represents as much as 52.0% of GDP; the average for the OECD countries being 11.0% and 49.3% for the region's average.⁶

The higher figure would indicate that informal economy in Azerbaijan has reached a critical level and mostly takes place by double accounting and tax evasion. Indeed, while the Statistical Committee announced 73 600 new jobs (74% of which were permanent) in 2009, individual income tax only grew from AZN 637 million in 2008 to AZN 642 million in 2009, against much higher expectations. Remittances inflows witnessed a similar trend over 2009, as recorded in the Social Security Fund. Moreover, due to little diversification of the economy, local experts estimate a high share of shadow money transiting in the real sector.

Although the prevalence of the informal economy impedes the expansion of the state budget, concealing real incomes of individuals also hampers their creditworthiness and thus the overall expansion of the economy. Moreover, the informal economy leads to undervalued GDP, tax base limits, budget constraints, an underdeveloped banking system and corruption. It can also hamper foreign investments. However, it also had a positive impact in creating employment (though fragile), developing infant business and fostering competition by reducing bureaucracy.

The government needs to bring this shadow economy back into the visible sector by providing reforms at the microeconomic level to foster infant business development and stimulate competition.

Analysis by economic sector

The share of agriculture in total GDP fell from 16.1% in 2000 to 6.7% in 2009 due to the huge expansion in mining and quarrying (major component of industry) which increased from 28% to 45% over the same period and consequently raised industry to an average of 58% of GDP between 2006 and 2008 from 36% in 2000. As a result, services declined from 51% in 2000 to 43.3% in 2009. In 2009, despite the economic crisis, industry successfully accounted for 50% of total GDP.

Agriculture

Despite tax exemptions, low fuel prices and a high level of subsidies, agriculture did not take off and still has low growth rates. Agriculture plays a dominant role in the reduction of unemployment, as it employs two-fifths of the total labour force and because 46% of the total country population live in rural areas. 55% of total land (4 757 000 ha) is arable. However, due to low investments in the sector – around 2% of total investments in the country (AZN 336 million out of a total of AZN 16.2 billion in 2008) – and comparatively lower wages, the agricultural labour force moved towards the construction sector and other services between 2001 and 2007. Although the employment share of agriculture fell from 41% in 2001 to 38.5% in 2009, overall growth in agriculture was positive over the same period, which can be attributed to improvements in total factor productivity.

General overview

Livestock breeding and plant cultivation are the major fields of the country's agriculture.

Table 2.4. Main crop production
(million tonnes)

	2000	2009
Cereals and dried pulses	1 540.2	2 988.3
Cotton	91.5	31.9
Tobacco	17.3	2.6
Potatoes	469.0	983.0
Vegetables	780.8	1 178.6
Vegetables and melon	261.0	410.8
Sugar beet	46.7	188.7
Sunflowers for seeds	3.7	14.4

Source: The State Statistical Committee of the Republic of Azerbaijan.

Azerbaijan's agricultural sector has been growing by 5% annually, doubling its production between 2000 and 2010. Since 1995, the production of cereals, potatoes, vegetables, sugar beet and sunflowers has increased significantly, while tobacco and cotton decreased, despite increasing international prices for cotton since 2005 (due to costs still higher than profits and slow renewal of equipment).

Livestock breeding has seen reasonable development, increasing various products by around 5% annually between 1996 and 2007. However, the share of imported livestock is expected to reach 60% of all agricultural imports in 2010. It is also expected that the country will meet its entire domestic demand for grain in 2010.

Table 2.5. Main livestock production between 2000 and 2009
(million tonnes)

	2000	2009
Meat	0.2	0.3
Milk	1.0	1.4
Eggs (billion units)	0.5	1.2

Source: The State Statistical Committee of the Republic of Azerbaijan.

One of the important objectives for Azerbaijan is boosting the economic development of rural areas and improving the agricultural output. As a result of reforms carried out since 1995 in the sector, excluding the Nagorno-Karabakh region, 99.5% of all land has been distributed by the government, of which 23% went to municipalities and 20% to private property.

Within the bounds of state support, agricultural output reached AZN 2.3 billion in 2009 (6.7% of GDP), down from a record of AZN 3.3 billion in 2008 before increasing to AZN 3.4 billion (USD 4.3 billion) in January-November 2010 (the highest level since independence). A record grain harvest, 2 988 300 tonnes, was collected in 2009, overtaking the previous year by 490 000 tonnes. However, the crisis hit plant-growing and cotton-growing, and cotton volumes even fell by 44.2%, to 30 900 tonnes. With Azerbaijan's real effective exchange rate appreciating only moderately, and institutional reforms in the business environment and the agricultural sector falling behind, the sector has been operating significantly below its potential (World Bank, 2009a). In production terms, the ineffective use of potential export sectors (pomegranates, potatoes, tomatoes, fresh fruits and vegetables and hazelnuts) and import-substitution (wheat, apples, and juices and concentrates) have prevented benefits optimisation.

Poverty remains high, particularly among the refugees and internally displaced persons resulting from the collapse of the USSR and the Nagorno-Karabakh conflict. Approximately 30-35% of the rural population live below the poverty line. These communities have adequate access to food, but they suffer from low productivity and high prices. Although there have been large improvements in infrastructure over the last years, with priority to supplying gas and electricity, living conditions remain poor. Health and education services also need to be improved.

The long-term growth of the economy, with rational use of existing manpower, natural and economic potential, increase in employment and reducing poverty levels have been the major problems of the sector. To improve agricultural performance, institutional and policy developments along with modernising infrastructure are also required. Moreover, the local banks are unwilling to finance the sector. The share of loans (in total loans to the real sector) issued to agriculture (and processing) decreased from 7.9% (AZN 37 million) in 2000 to 4.7% (AZN 395 million) in 2009.

In addition to investment policy, special tax or credit incentives can be considered. There are two priorities for agricultural development in the country: foreign finance and technologies and manufacturing experience. Trying to raise the confidence of landowners is a major issue. This increased confidence would encourage them to use their potential and expand commercial collaboration between local workers and foreign businesses. Efforts should be made to stimulate local workers to find contacts abroad, to establish relations and to produce export-oriented goods. Moreover, steps should be taken in focusing the attention of banks on financing the sector.

Major reforms

The government has undertaken real efforts for the sector's development through specific policies and programmes⁷ and by allocating funds from the state budget since 1995. As a result of serious structural transformations in agriculture, the state farms and the collectives were liquidated and their property was divided between their members. The transition to a market economy and a new kind of property increased farmers' incomes and reduced poverty. Though land distribution was a first step for access to financing, more favourable conditions are needed to fully develop the sector.

The government's "State Programme on Social-Economical Development of the Regions of the Republic of Azerbaijan", which came into force for 2009-13, and the "State Programme on Reliable Provision of the Population with Food in the Azerbaijan Republic" adopted in 2008 and implemented in 2009-15, are aimed primarily at achieving food security and the development of rural areas.

In 2004, the government established the "Agroleasing" Open Stock Company, to strengthen the material and technical basis of agricultural producers and to supply agro-technical services. In particular, farmers can access agricultural machinery, fertilisers and thoroughbred cattle through the company. The company provides softer conditions than the market for loans and prices for equipment and machinery and large-scale projects.

Subsidy policies

Subsidies to agriculture by the state are among the highest among the Commonwealth of Independent States (CIS) countries. On the other hand, joining the World Trade Organization (WTO) may have a negative effect on national agriculture outputs because of lower customs duties, reduced subsidies and declining competitiveness. Hence, Azerbaijan hopes to join the WTO as a developing country, which will allow the maintenance of high financial support to the agrarian sector. The government allocates special subsidies to wheat producers of AZN 40 per hectare and per year since 2008 for fuel and motor oil and AZN 80 million is annually allocated to farmers from the state budget. In addition, the National Fund for Entrepreneurship Support lends a certain amount of funds for agricultural projects. The "State Programme on Reliable Provision of the Population with Food in the Azerbaijan Republic" (2009-15) is aimed at achieving sustainable agricultural development in the country.

Industry

General overview

The "Contract of the Century" laid the foundations for development of the petrochemical industries of the country with a transition from old Soviet technologies to the latest western ones. Among significant socio-economic impacts associated with the involvement of major foreign oil companies are skill enhancement, long-term employment opportunities and improved working conditions.

The country's manufacturing industries have grown considerably since 1995 and industry accounted for 50% of GDP in 2009. Located mostly in the industrial cities, Azerbaijan manufactures equipment for the oil and gas industry, electrical equipment, various appliances and technical instruments. The leading branches of heavy industry are power, manufacturing, petrochemical and chemical production.

The light industry of Azerbaijan consists of basic manufactured consumer goods. It also includes processing of foodstuffs, alcoholic drinks, textiles and building materials. Raw materials transformation used to represent the bulk of light industry in Azerbaijan but the retrenchment of wool and silk production severely lowered its share in total production. However, light industry does have certain prospects. Though suffering from outdated equipment, the existence of raw-materials resources and other commodities could stimulate significant capital inflows and develop the sector; especially in textiles and clothing which were one of the most important industries in the Soviet era.

Although there are advantageous investment opportunities, apart from the oil and gas sector, the country has failed to attract large volumes of greenfield investments oriented towards exports.

Energy sector

Oil

Oil and gas production in the country is carried out by SOCAR, one of the largest oil companies in the world. Established in 1992, SOCAR controls a full production cycle – “from drilling to the consumer”. While the sector employs only 1% of the country’s total labour force, SOCAR represents 60 000 people.

The Caspian basin field has about 3-5 billion tonnes of oil and 5 trillion m³ of gas, according to SOCAR. At the same time, estimates of hydrocarbon deposits in the Azerbaijani sector vary from 4 to 8 or 10 billion tonnes of conditional fuel. It is also expected that Azerbaijani oil revenue will amount to an average of USD 200 billion over 20 years between 2005 and 2025. IMF projects the State oil fund (SOFAZ) assets to increase by 6.5 times reaching USD 98 billion in 2015 from USD 15 billion in 2009, which could lead to human capital development in the country. Indeed, although the oil sector is pulling the economy, it only accounts for about 1% of total employment. Therefore, a National Employment Strategy was initiated in 2002 by the government to convert “black gold into human gold” (oil wealth into human development) by enhancing educational programmes and training, easing the population’s access to social infrastructures and technical assistance. According to BP, the oil companies’ expenditures in social fields accounted for a total of USD 39 million between 2002 and 2008. In 2009, BP spent around USD 3 million in Azerbaijan on sustainable development projects, like BP’s new Geosciences and Engineering Speaker Series (BPGESS) initiative, or the Memorandum of Understanding (MOU) signed between BP Azerbaijan and the Baku-based Qafqaz University (BP Azerbaijan Business Update, 2010).⁸

FDI, since 1995, has revitalised the country’s oil sector through the development of new large-scale projects and the restoration of existing facilities. To date, Azerbaijan has signed over 20 major field agreements with approximately 30 companies from 15 countries. Azerbaijan’s increase in oil production since 1997 has mainly come from the Azerbaijan International Operating Company (AIOC), an international consortium which represents over 70% of Azerbaijan’s total oil exports. AIOC, which is composed of ten big international oil companies,⁹ operates the offshore ACG mega oil field. Oil production from ACG accounted for 193 million tonnes between the date of commencement (1997) to the first quarter of 2010, and Azerbaijan’s participation in oil production by the consortium reached 72.6 million tonnes in Q1 2010, according to Trend news agency. Beside ACG, AIOC also made a significant investment on construction of the South Caucasus Pipeline (SCP) and the BTC pipelines. British Petroleum, in Azerbaijan since 1992, is the largest foreign investor. Oil production in Azerbaijan increased from 180 000 barrels per day in 1997 to 1.02 million barrels per day in 2009. Oil production from AIOC and SOCAR fields is expected to reach 1.2 million barrels per day in 2010 and could be sustained at a volume of 1 million barrels per day until 2019 if AIOC and the government approve the USD 10 billion project to tap the oil reserves below the ACG fields (Energy Information Administration 2010). Expectations have been prudent since BP’s setback in the Gulf of Mexico.

Not discovering new oilfields is the major condition on forecasts of oil exhaustion by 2020. It is also possible that new reserves could be insignificant and their exploitation could demand considerable capital expenses.

Two major fields are still to be explored for production expansion: lithologic and stratigraphic strata – 30% of which were not fully assessed regarding their hydrocarbons production potential (Aliyev, 2010) – and the development of off-shore deposits, mostly in the Caspian Sea which is only exploited to 34% of its total capacity. Moreover, as the legal status of the Caspian Sea is still undefined, many offshore fields have been left untapped. While ACG is the most successful project, not all of Azerbaijan’s foreign investment projects have been successful, with several projects announcing disappointing drilling results and several production-sharing agreements shutting down in recent years.

In 2009, from 50.9 million tonnes of oil, Azerbaijan exported 44.3 million tonnes to 24 countries, according to SOCAR. The remaining 6.09 million tonnes were dispatched to refining. SOCAR’s share from total exports was 29.9 million tonnes, while the remaining 14.4 million tonnes went to the other international companies involved. It is expected to produce 52 million tonnes of oil in 2010.

Azerbaijan also has two oil refineries, operated by SOCAR, with a refining capacity of 22 million tonnes of oil per year. The country is highly interested in acquiring oil refineries around the Black Sea region. For example, it already holds 51% of the Turkish company Petkim, since 2007.

Natural gas

Prior to starting up the Shah Deniz natural gas field in 2007, Azerbaijan used to be a net natural gas importer from Russia. Now it has become a net exporter. In 2009, Azerbaijan produced 23.6 billion m³ of natural gas but only consumed 10.6 billion m³. Almost all of Azerbaijan's natural gas is produced from offshore fields. The country's leading natural gas fields are the ACG and the new Shah Deniz natural gas field. The country's Sangachal Terminal, is one of the world's largest integrated oil and gas processing terminals. It receives, stores and processes both crude oil and natural gas from both gas fields, which are then shipped through the different pipelines for export. The main gas pipeline is the SCP, also known as Baku-Tbilisi-Erzurum (with a capacity of 16 billion m³ per year), which runs parallel to the BTC oil pipeline.

A major gas production increase is expected to come from the continuing development of the Shah-Deniz field. Moreover, Shah Deniz is one of the world's largest natural gas fields, discovered in the last 20 years. It has been estimated by SOCAR to have produced 28.5 billion m³ of gas in 2010.

With the start of Shah Deniz's second phase in 2014-15, Azerbaijan will be able to double production to about 40 billion m³ of gas per year. Although the figure is below 1% of the European consumption of gas, it can make the country a valuable player for European markets. It will also lead to further development of the gas industry and initiate prospects of USD 20 billion investment to the national economy. For this purpose, it is necessary to exploit high extraction technologies and to define the major routes of gas transportation. One of them could be the Nabucco gas pipeline project (construction beginning in late 2010) for gas transportation from the Caspian region and the Near East to the European Union (EU).

Industrial production

According to the State Statistical Committee in 2008, the degree of deterioration of basic production assets varied between 54% and 73% of total fixed assets in many branches of the manufacturing industry, such as metallurgy, chemistry, recording, electrical machinery, equipment, transport and mineral products. The intensification of manufacturing and raising quality to international standards are the most important issues. Lack of competitiveness is caused by low technological levels of production, poor product lines, weak diversification (both of products and enterprises) and reduction of the share of production of manufacturing industry in total exports. Many enterprises in the chemical, petrochemical, oil refining, electro-technical industry and oil mechanical engineering work at only 30% of their total capacity.

The mining industry accounted for 78.6% of total output, while share of manufacture and distribution of electric power, gas and water accounted for 4.7%: only 16.7% came from the manufacturing industry in 2008. A total of AZN 27.2 billion was invested in industry between 2000 and 2008, of which AZN 19.7 billion (72.4%) was FDI and AZN 7.5 billion (27.6%) were domestic investments. An insignificant part was directed towards enhancing technological innovation: just AZN 113 million between 2004 and 2008.

Business weakness results from lack of own capital resources, insufficient financial support from the state, low demand for new products, high innovation costs, high economic risk, long-term payback, low innovative potential of enterprises, unqualified personnel, a lack of information on new technologies, sluggish reaction to innovations, lack of information on commodity markets and lack of possibilities for co-operation with other enterprises and scientific organisations.

Table 2.6. Output of industrial products
(current prices, AZN million)

	2000	2005	2006	2007	2008	2009
Total industry	3 639.5	9 290.5	15 509.4	22 441.4	29 697.6	22 203.7
Chemical industry	102.2	199.0	194.7	213.0	219.7	110.4
Extractive industry	1 625.8	5 672.6	10 565.9	16 412.8	22 631.3	16 798.6
Manufacturing industry	1 552.5	3 074.2	4 312.2	4 920.4	5 701.4	4 199.2
Production and distribution of electricity, gas and water	461.2	543.7	631.3	1 108.2	1 364.9	1 205.9
Manufacture of food products, including beverages and tobacco	698.9	1 197.6	1 278.3	1 409.3	1 550.0	1 644.6
Textiles and sewing industry	32.7	51.1	72.0	59.4	76.5	62.1
Manufacture of leather, leather products and footwear	2.7	4.5	6.9	16.2	17.0	15.3
Manufacture of wood and wood products	1.9	9.6	12.2	18.4	15.6	8.0
Pulp and paper industry; publishing	6.0	26.2	31.9	37.2	57.0	50.6
Manufacture of refined petroleum products	560.9	836.8	1 821.2	2 118.2	2 400.0	1 345.6
Manufacture of rubber and plastics products	3.1	23.5	27.7	37.1	70.0	53.4
Manufacture of other non-metallic mineral products	23.1	135.4	165.1	253.0	352.5	359.1
Metallurgy industry and fabricated metal products	11.6	328.2	403.4	403.6	515.6	170.6
Manufacture of machinery and equipment	34.0	36.6	60.1	98.6	120.0	78.8
Manufacture of electrical optical and electronic equipment	10.8	25.9	34.0	48.3	56.2	64.4
Manufacture of transport means and equipment	57.7	165.2	173.9	169.3	206.8	203.2
Other sectors of manufacturing industry	6.9	34.6	30.8	38.8	44.5	33.1

Source: State statistical Office of Azerbaijan.

Construction and infrastructure

Construction grew from independence, with fixed assets reaching AZN 8 342 million in 2008, from AZN 667 million in 2000, but declining to AZN 2 438 million in 2009. The sector employs 225 000 people (5.5% of the total workforce) and the average monthly nominal wages of construction employees increased from AZN 83.3 in 2000 to AZN 449.9 in 2009. The sector accounted for 7.4% of GDP in 2009.

The construction boom began with the BTC pipeline construction in 2001 and continued until 2004, leading the sector to record the highest growth, next to oil, between 2001 and 2005. Pipeline construction generated confidence in the national economy and, along with the expansion of the state budget starting from 2005, a considerable increase in incomes, which boosted demand for real estate, led to a construction boom, particularly in the capital. This was accompanied by constant increases in real estate prices, which, however, went down after the start of the crisis.

The construction sector experienced a slowdown in 2009 due to the international crisis and the value of works at AZN 3 191.4 million, was down by 15.7% compared to 2008. The decrease affected both private and public construction volumes, by 10.2% and 16.8% respectively. However, it did not reflect a decrease in prices in the domestic market for real estate. As an anti-recession stimulus measure, in the middle of 2009 the government resumed mortgage lending which had been paused since 2007.

Capital investments in infrastructure had increased since 2003 and, backed by oil revenues, had tripled since 2006, but were slightly cut due to the crisis. Main public infrastructure projects such as power, roads and water had been a priority, followed by the social sectors. Improvements in power supply sparked development in the light industry, food processing and other manufacturing, while improvements of roads reduced transportation costs, mostly in corridors promoting cross-border trade and transit of goods. Improvements in these infrastructure projects are very important and will likely be continued, offering potential for growth and employment creation. There is some evidence that infrastructure projects have attracted some FDI in support of public spending, but manufacturing, assembly and related services have not.

Updating and expanding the infrastructure of the country remains a priority for Azerbaijan, since it is fundamental for the development of the non-oil sector and for attracting investment. The country will positively benefit from improving and modernising the Europe-Caucasus-Asia (East-West) and North-South corridors. Indeed, total cargo transportation via the East-West corridor on the Azerbaijani side increased from 20 million tonnes in 2000 to 47 million tonnes in 2009, while the share of transit cargo turnover accounted for 50% in 2009. So construction and rehabilitation of major projects in these directions require acceleration which would increase volume and favour faster movement of goods to domestic and international markets with lower operating costs and higher efficiency.

In addition, the sector's development is constrained due to insufficient administrative capacity to implement necessary projects. It also suffers from the slowness of fixed asset renewals and of the rapidity of their depreciation, underdevelopment of integrated systems, low information provision for the sector's activity and legal inconsistencies.

Policy implications

The government has undertaken several steps and adopted state programmes since 2006 to integrate into the international system, enhance transit potential and support competitiveness. According to the World Bank, the government intended to accelerate rehabilitation of regional and local roads from 2008. It was also estimated by the bank that approximately USD 1.1 billion is needed annually to develop infrastructure utilities and public services over the next ten years.

The private sector share in construction increased to 87% in 2008 from 63% in 2000. However it averaged 95% between 2002 and 2005. The constraints faced by the construction sector stem from the large role played by the state, the huge regulatory burden and the absence of competition. Construction permit formalities need to be reduced to attract more investment to the sector and create a more competitive environment.

There is also potential for the oil and gas industry, by supplying demand for basic equipment and machinery, metalworking, technical services, transportation, food, and chemical and petrochemical industries. Local enterprises will need to comply with international standards and will require solid capital resources, improved delivery requirements and developed capacity to respond to large orders.

Services

The share of services in GDP accounted for 44.4% in 2009; overall, services grew by 9.1% in the same year. The sector accounted for approximately 49% of total employment in 2008. The major share of employment in the sector is in trade and repair (16% of employment), education (8.5%), construction, real estate and tenancy (10%), transport, communication and warehousing (5%).

Furthermore, the country has a fairly liberal services sector. The share in GDP of liberalised activities in some sectors reaches up to 99% (99% for trade, 87% for construction and 82% for transport) while the overall private sector contribution to GDP is 85%. As a very dynamic branch of the non-oil economy between 2000 and 2008, growth of this sector was due to increasing demand for services and the favourable location of the country for trade and transport.

The demand for services grew rapidly in line with the development of the oil industry and associated sectors, indirectly increasing employment in other sectors.

Telecommunications

Telecommunications in Azerbaijan have generated a competitive environment with a decent level of competition. There were more than 70 enterprises competing in the telecommunications market, 80.3% of which were private (up from 73.7% in 2006). Currently, telecommunications companies can render more telecommunications services than consumers demand. Moreover, negotiations between the Ministry of Communications and Information Technology of Azerbaijan and several communications companies were underway in 2010. These will result in the country's first communications satellite, planned for early 2012.

According to the Ministry of Communications and Information Technology of Azerbaijan, the information and communication technology (ICT) development indicator of Azerbaijan has twice exceeded its world growth rate as a contribution to GDP (13.1% in Azerbaijan). At the end of 2009, the number of new connections in the mobile communications market in Azerbaijan was 1.1 million and 85.6% of the population had a mobile phone – above the world average of 25%. The implementation of the 3G system also became one of the events in the mobile communications market in 2009. However not every mobile communications company bought a licence to provide 3G. There are three mobile communications operators in the country under GSM (global system for mobile communications) standard, which are Azercell Telecom Ltd.,¹⁰ Bakcell Ltd. and Azerfon Ltd., and two CDMA (code division multiple access) operators, Catel Ltd and Naxel Ltd. If it is true that only Azerfon provides 3G technology, there are no market restrictions and the sector is open for new investment for other operators to be equipped with the technology. By providing a wide area of wireless interactive connections (including telephone, Internet, video calls and TV), the 3G system could help promote a more dynamic and challenging business environment by further connecting the country to its main trading partners.

The telecommunications sector accounted for 2% of GDP in 2009. The value of communication services increased from AZN 154 million in 2000 to AZN 1.03 billion in 2010 and its average volume growth for the last five years reached 35%. Mobile services account for more than 60% of total revenues of the communications sector, the world average being around 30%. This can be characterised as an absence of commercial motivation of fixed operators (as well as mobile communications operators, to a certain extent) to build networks and render services in regions (in countryside and settlements with a low population density). The telecommunications market of Azerbaijan is stable following privatisation and structural reforms and the state continues to hold stocks in major Azerbaijani communications operators.¹¹

The level of Internet penetration in Azerbaijan exceeded 40%, according to the ministry, with more than 30 Internet providers in Baku; competition is much lower, if at all, outside the capital. However, a European Bank for Reconstruction and Development factsheet (EBRD 2011) evaluates the penetration to be as low as 14%, while 70% of subscribers use dial-up connections. Internet tariffs have steadily decreased, by eight times since 2007, but remain among the highest in the region. There is room for more competition in this sector, as only two companies can supply backbone platforms to providers and a few companies can bring Internet to final consumers through fixed-line centres, which could result in an oligopoly if new companies do not enter the market. Moreover, Azerbaijan plans to fully shift to digital TV in 2012. There is also great potential in this area, as local cable TV companies will be able to provide Internet directly to the final consumer, bypassing fixed line centres.

Transport

Azerbaijan is located at the crossroads of main international traffic routes, such as the Silk Road and the North-South corridor. Therefore, transport plays a significant role for regional economic development and greater co-operation.

Road transport is the most important form of transportation in Azerbaijan. Others include railways, aviation, maritime and pipeline transport. In 2009, transport's share in GDP was 6.6%, while transportation of goods rose by 3.7%, compared to 2008. This indicator has risen 1.6 times from AZN 117 million in 2004 to AZN 190 million in 2009. In 2009, 49.7% of overall freight was carried by road and 32.7% by pipeline. The private sector accounts for 83.9% of the transport sector.

Azerbaijan has three major export pipelines, which are the BTC,¹² Baku-Novorossiysk and Baku-Supsa¹³ pipelines. BTC is the most important route, with a capacity of 1 million barrels a day,¹⁴ and began

exporting Azeri Light oil in July 2006. In 2009, its capacity expanded to 1.2 million barrels per day by using drag-reducing agents. In 2009, 50.5 million tonnes of oil passed through oil pipelines. BTC accounted for 38.2 million tonnes in 2009 (of which 1.9 million tonnes are Kazakhstan's oil) and 124.7 million tonnes since its commencement to June 2010. The first volumes of oil from Kazakhstan arrived in BTC in late 2008. Later deliveries were suspended due to dissatisfaction over the tariffs for pumping. Russia and Azerbaijan agreed on transit of the Azerbaijani oil via the Baku-Novorossiysk pipeline in 1996, assuming 5 million tonnes of oil per year at a tariff of USD 15.67 per tonne, whereas tariffs for transportation of oil via BTC and Baku-Supsa vary from USD 3-4 (for AIOC shareholders) and from USD 2-4 respectively. Therefore volumes of Baku-Novorossiysk decreased substantially with the start of BTC from 4.5 million tons in 2006 to 1.3 million tonnes in 2008 (however it increased to 2.5 million tonnes in 2009).

A "Transport Sector Development Strategy for Azerbaijan" has been drafted by the Ministry of Transport, with the assistance of international consultants and the financial support of the Asian Development Bank (ADB). This strategy sets the agenda and the key priorities in transport policies and managerial structures for 2006-16. It aims at improvement of the country's transport sector performance, identification of strategic priorities and assessment of transport facilities as well as being a guide for the government's investments in the sector and the lending strategy for both domestic and international sources.

Banking and financial sector

Positive macroeconomic trends, such as the absence of large-scale bankruptcies and steady growth, outline the development of the banking system of Azerbaijan since 2005. From independence, the number of banks in Azerbaijan was considerably reduced owing to bankruptcies, mergers and licence withdrawals, which forced the remainder to strengthen by mergers and acquisitions. Thanks to this process, the Central Bank managed to increase equity requirements. Measures were also taken on restructuring and tightening minimum capital requirements and increasing the capital adequacy ratio. The total regulatory capital of banks increased 2.9 times between 2006 and 2009 to AZN 1 758.9 million. Assets tripled over the same period to AZN 11 665.2 million.

The growth of local banks was intensive, thanks to international borrowing and the growth opportunities before 2008. In 2009, bank assets grew by 13.5% (AZN 1.4 billion). While total assets decreased in the first half of the year due to the repayment of an external debt, the trend reversed in the second half. Moreover, in 2009, bank loans grew by 17.3% (AZN 1 214 billion), reaching AZN 8 230 billion at the end of the fiscal year.

To exploit its economic potential, Azerbaijan has been urging the financial sector to make credit more easily available, but financing is provided against collateral. Indeed, property rights do not allow clarity on collateral (both the banks' and the borrowers' rights are ill-defined). It is therefore difficult to collect credit information and to access credit. However, with the population's trust in banks beginning to increase, the lending sector's aversion trend is rapidly reversing.

The Azerbaijani banking system remains very attractive for neighbouring countries and the EU. There is, however, a dilemma because, although restricting access of foreign banks to the domestic market would protect domestic banks, it would also negatively affect the global competitiveness of Azerbaijani enterprises.

Azerbaijani banks are currently focusing on the domestic market, apart from the International Bank of Azerbaijan¹⁵ (IBA) which has two subsidiary banks, in Russia and in Georgia, and also has representative offices in London, Frankfurt, Luxembourg, New York and Dubai.

Policy Implications

The economic development and business activity accompanying growth in the banking and financial system has increased demand in the domestic economy for credit. The banking system has, therefore, increased its credit volumes to AZN 8.2 billion in 2009 – from AZN 2.4 billion in 2006. The highest growth of credit activity was in private banks, where the share of loans in the total at the end of 2009 reached 51.4%.

In addition, the regulatory authorities have successfully implemented several policies and procedures towards strengthening the financial system of the country. Much attention nowadays is given to risk

management with new rules established for lending. Since 2004 the Central Bank made Corporate Governance standards¹⁶ obligatory, while considering the Basel 2 recommendations. Moreover, in February 2009, a new law was adopted on "Combating Money Laundering and the Financing of Terrorism". Finally, a Financial Monitoring Organ was established and due diligence procedures are now being discussed. Nevertheless there are still shortages in equity-capital, insufficiency of base deposits, poor credit culture, high probability of deterioration of assets and low operational efficiency. Moreover, many private banks are closely connected to industrial and trading groups. Such positions create serious risks in information and corporate governance and can affect estimations of risks. With 47 banks operating in the country, there is still a need for structural reforms, consolidation and a further reduction in the number of small and impractical banks. Additional problems include raising the level of financial intermediation, expanding the range of products, diversifying sources of incomes, raising efficiency and developing new tools and mechanisms for improving the quality of operational activity and risk-management.

A growth of micro lending in the banking sector is a recent qualitative tendency. Its basic advantages are high profitability, considerably smaller risk and larger coverage of the economy, both geographically and in the client base. Micro credit also has important macroeconomic value in supporting self-employment, particularly in rural areas.

MAIN MACROECONOMIC POLICIES

General overview

There is sufficient macroeconomic stability in Azerbaijan based on solid foreign reserves. These reserves had reached USD 22 billion by the first quarter of 2010, which in turn guaranteed the state budget durability and partially compensated for the reduction of any external sources of liquidity in the economy. As a whole, economic growth and employment have been protected from the global crisis, precisely due to these reserves.

Fiscal policy

The fiscal position of Azerbaijan has been strengthening since 2005, with budget revenues increasing by 30–40% on average annually, from AZN 1.2 billion in 2003 to AZN 10 billion in 2008 and 2009. These resources benefit from high oil revenues, but fall under pressure from lower prices with consequences for the macroeconomy. High inflation expectations also rose with the oil boom.

The government¹⁷ supported the banks and the state companies by financing those with difficulty in repaying foreign debt obligations in 2009.

Taxation

There are two tax system regimes in the country, the statutory tax regime governed by the Tax Code and the Production Sharing Agreements (PSAs) concluded by the oil companies.

The tax ministry lacked the resources planned in 2009, as only AZN 4 113.5 million was collected that year (around 71.5% of total planned resources) – 27.8% less than in 2008 (for a total of AZN 5 695 million in 2008). Of the AZN 4 113.5 million collected in 2009, 30.9% (AZN 1 272.6 million) and 12.5% (AZN 513.2 million) came from SOCAR's and AIOC's profit taxes shares respectively. In 2010, taxes contributed to 41% of the budget and reached AZN 3 127.5 million, around AZN 19 million more than planned.

Table 2.7. Taxes (percentage revenues)

	2000	2009
On goods and services	46.3	59.8
On incomes, profits and capital gains	30.8	32.4
On international trade	8.9	4.2

Source: The Statistical Committee of Azerbaijan Republic.

Since 2008, all value-added tax (VAT) operations (off-sets) are held in a VAT depository account, run by the State Treasury of Azerbaijan. Although centralised VAT prevents fraud and corruption, it delays money circulation and decreases circulating assets, which are major concerns of local SMEs. Indeed, previously, payments were circulated just between counterparts in only one payment, which was susceptible to concealment. Since 2008, all VAT payments are required to be wired to the opposite taxpayer's special tax ID account opened at the central treasury agency. Subsequent off-set settlements are held by this account. Thus each payment made by a buyer is paid with two payment orders which consist of basic payment for goods or services and VAT.

The main revenue – income tax (levied on the employee's income at progressive rates ranging from 0% to 30%) has been lowered from 35% to 30% (the maximum rate), along with the profit tax from 22% to 20% since January 2010. Nevertheless, direct tax rates are still high in Azerbaijan which is not necessarily attractive both for domestic and foreign investments in the non-oil sector. It also increases the incentives for firms to operate informally.

Budget

The persistence of the government on setting the price for oil at USD 70 a barrel in the state budget for 2009 had a significant negative impact. As prices for oil fell, the approved 2009 state deficit of AZN 178 million widened to AZN 241.1 million (0.7% of GDP). The approved 2009 budget revenues were issued at AZN 12 177 million, but its execution only cost AZN 10 325.9 million (84.8%), below the 2008 figure of AZN 436.8 million (4.1%). The State Oil Fund contribution reached 47.6% of total revenues. Expenses of the state budget of 2009 were approved at AZN 12 355 million.

Table 2.8. The 2010 budget

Budget deficit (% GDP)	3.9
GDP growth (%)	7.4
CPI growth (%)	3.0
Exports growth (%)	32.1
Imports growth (%)	25.0
Minimum subsistence level (AZN)	87.0
Social aid poverty criteria (AZN)	65.0
Minimum monthly wage (AZN)	85.0*
SOFAZ** growth (AZN billion)	11.4

Notes: *As of 1 September 2010; ** State Oil Fund of the Azerbaijan Republic.

Sources: EIU, IMF, State Statistical Committee.

In 2010, the government decided to end the tendency of increasing the state budget every year; the 2010 budget was even ratified below that of 2009. State budget revenues were expected to reach AZN 8.0 billion (USD 10.0 billion) and expenditures AZN 8.1 billion (USD 10.1 billion), a deficit of AZN 1 249 billion with an oil price set at USD 45 per barrel. However, according to international forecasts, the price of oil in 2010 was expected to reach USD 70 per barrel, thus solving Azerbaijan's deficit problem. The barrel finally reached USD 88 in December 2010. The budget was finally executed with revenues of AZN 7.5 billion and expenditures of AZN 6.8 billion, which resulted in a budget surplus. Out of this budget, 48% of income came from SOFAZ and 42% from taxes. 30% of all expenses was directed to construction and natural resources and 25% for social protection and education. Transport and communication only received 0.5% of the total budget, while housing barely reached 2%. The 2011 state budget has been drafted for revenues totalling AZN 12 billion and expenditures of AZN 11.6 billion.

The State Oil Fund of the Republic of Azerbaijan (SOFAZ)

SOFAZ was established in 1999 "to ensure inter-generational equality of benefit with regard to the country's oil wealth". The fund accumulates surpluses received from hydrocarbon sales. SOFAZ also works toward socio-economic progress and macroeconomic stability, shifting development to non-oil

sectors. The creation of SOFAZ was also necessary to prevent the potentially negative impact of substantial currency inflows to the national economy that could have led to its appreciation and to the decline of domestic competitiveness. The assets of SOFAZ grew by 32.8% year on year (yoy), as of 1 January 2010, accounting for AZN 11.97 billion (USD 14.90 billion), compared to AZN 1.28 billion (USD 1.39 billion) in 2005.

Monetary policy

The government pursues a policy of stabilisation of the exchange rate, in the light of oil revenue growth. The Central Bank has been buying the surplus of foreign currency from the domestic market since 2005, as energy and transit revenues flow into the country, and this explains the growth of its reserves – part of those reserves were sold during the crisis to maintain the macroeconomic and financial stability.¹⁸

The main objective has been to peg the manat to the US dollar as the stability of the exchange rate is closely linked to the country's macroeconomic improvement; the main source of income being the international trading of oil in US dollars. Among the possible intermediate monetary indicators, the rate of the manat, even more than money supply or the refinancing rate, is the most controlled and predictable reference point for achieving the objectives of price stability and the positive functioning of the financial system. Inflows of money usually cause appreciation of the national currency by increasing currency reserves, thus complicating the inflation tightening. To prevent the strengthening of the manat, the Central Bank influenced the nominal exchange rate, which, in 2010, was equal to zero against other currencies.

Recent developments

The deterioration of the economic situation in 2008 was due to falling remittances and construction, blockage in the bank lending process and the collapse in exports, worsening the balance of payment indicators.

Table 2.9. Monetary effects of the crisis in 2007, 2008 and 2009

Year	2007	2008	2009
Current account balance (USD billion)	9.0	16.4	8.3
Current transfer balance (USD billion)	1.0	1.1	0.7
Consumer Price Index (%)	4.4	8.9	2.9
Total deposits (AZN billion)	1.66	1.94	1.92
Total deposits in foreign currency (AZN billion equivalent)	1.75	2.82	2.74
Exchange rate AZN/USD decrease (%)	-2.99	-5.24	0.26

Sources: The Central Bank of Azerbaijan Republic, the State Statistical Committee of Azerbaijan Republic, WEO 2010, EIU.

Inflation and prices

Maintaining price stability is the main priority of the Central Bank of Azerbaijan. Inflation has been increasing since 2004, mostly due to fiscal expansion that has supported domestic demand. Between 2004 and 2008, inflation averaged 12.8%, while it was as low as 2.1% on average between 2000 and 2003. In 2009, inflation fell dramatically to 1.5% as international commodity prices fell along with domestic and external demand. Exchange-rate policy also played a vital role. The IMF forecasts the possibility of inflation increasing to around 4% in 2010, as does the Central Bank projection, but the latter hopes to maintain inflation just one point below the IMF's projection, not excluding further amendments imposed by the effects of increased demand.

Table 2.10. Inflation rates
(percentage)

	2008	2009	2010*
CPI	20.8	1.5	5.5*
PPI	11.6	-19.3	31.4*
CI	22.1	1.6	1.9**

Notes: *from January to November; **from January to April.

Source: The State Statistical Committee of Azerbaijan.

Difficulties in predicting price rises in the economy relate to the unpredictability of the cost of commodities and foodstuffs in the world market. Azerbaijan has been warned by the international financial organisations that inability to constrain inflation could worsen the investment climate. Moreover, price rises pose risks to the welfare of the population and the national economy.

Monetary aggregates (M2, Reserves)

The Central Bank achieved neutralisation of the money supply by injecting liquidities into the economy through market operations in 2009 – AZN 3.7 billion on 1 May 2009 and AZN 5 billion on 1 January 2010, for example. The monetary base began a negative trend in Q1 2009, before returning to positive growth starting the second quarter. It was AZN 4.9 billion at the end of that year.

Net foreign assets of the Central Bank decreased by 16.7% yoy amounting to AZN 4.3 billion in 2009, down from the record level of AZN 5.2 billion yoy (16.2%), compared to an increase of 44.9% (from AZN 3.5 billion) in 2008. Net domestic assets accounted for AZN 650 million at the end of 2009. In 2009, M2 was AZN 6.2 billion, increasing by 1.5% (AZN 0.9 billion) yoy against a growth in 2008 to AZN 1.7 billion (38.2%). In 2009, the money reserves of the Central Bank dropped by 15.7% (USD 961.4 million) compared to a 52.8% growth in 2008 (USD 2.1 billion). They increased by 19.6% (USD 1.17 billion) in 2010. Total reserves of the Central Bank amounted to USD 5.96 billion as at November 2010.

Exchange rate

In early 2008 the Central Bank began implementing a two-currency basket regime (the US dollar and the euro), which is regularly revised. The basket proportion in 2010 was 90% USD to 10% EUR, while initially it was set at 70% to 30% respectively.

The rate of the AZN against the USD throughout 2009 was reduced by only 0.26%. The country's currency market was subject to pressure in the international markets, an increase in service charges of external obligations of the banking system and psychological waves of consecutive devaluations in the neighbouring countries (Central Bank of Azerbaijan Republic, 2009). However, these factors were neutralised by the active intervention of the Central Bank and a stable rate of national currency was maintained. The peak pressure of the market came in January-March 2009. As a result, sales of currency by the Central Bank in the foreign exchange market reached USD 1.26 billion, 1 billion of which was sold in the first quarter of 2009. During 2009, activity in the domestic exchange market remained at a high level and the volume of operations in the market reached USD 31.8 billion.

The containment of the exchange rate AZN/USD in 2009 by the government helped to prevent an excessive rise in imported goods prices, depreciation of deposits, increased foreign borrowings and high dollarisation.

The surplus of the balance of payments was also a key factor in maintaining the stability of the AZN. Therefore, as long as the Central Bank can secure the surplus of the balance of payments, the manat's stability will be assured.

On 10 January 2010, the Central Bank moved to a bilateral exchange rate (AZN/USD) and abandoned the use of a dual currency basket (USD/EUR) to determine the manat rate, as it aims to expand exports and economic growth.

External sector

The government of the Republic of Azerbaijan has been negotiating to join the World Trade Organization (WTO) since 1997. There are still legislations which diverge from WTO regulations and therefore require adaptation. A legislative programme to make the necessary amendments required by the WTO principles has been established.

Main figures

The foreign trade balance dropped by a factor of 1.6 between 2008 and 2009, from USD 23 billion to USD 14.6 billion. Exports dropped from USD 30.6 billion to USD 21.1 billion (1.45 times), while imports fell from USD 7.6 billion to USD 6.5 billion (1.16 times) over the same period. Azerbaijan's main trade partners in 2009 were Italy (20%), United States (11%), France (7%), Israel (7%), Turkey (6%) and Russia (6%).

Exports

Crude oil accounts for USD 17.9 billion of the total USD 19.1 billion of oil product exports. AIOC's share in crude oil exports made up USD 17.1 billion. The country's non-oil-gas exports accounted for USD 1 127.3 million in 2009. Azerbaijan's goods export structure shows a clear specialisation in oil and oil-related products (more than 90% of total exports in goods) in which it has a RCA (relative competitive advantage), very different from the other South Caucasus countries and Ukraine (conformity index close to 0).

Table 2.11. Share of main exports of goods by category in total exports, 2009

Classification	Exports (USD thousand)	Share (%)
Total	14 698 496.5	100
<i>Of which:</i>		
Live animals	665.8	0
Vegetables and plant materials	226 126.2	1.5
Animal and vegetable fats and oils and related products	128 867.5	0.9
Food products, beverages, spirits and vinegar, tobacco	170 431.2	1.2
Mineral products	13 644 201.8	92.8
Products of chemical industry	33 682.2	0.2
Plastic, rubber and articles thereof	60 783.2	0.4
Rawhides and leather articles	7 838.6	0.1
Wood and wood articles	942.6	0
Paper and paperboard	2 476.3	0
Textiles	45 448.0	0.3
Footwear, headwear	159.2	0
Articles of stone, cement and ceramic	1 191.4	0
Pearls, precious stones, precious metals	24 949.5	0.2
Miscellaneous articles of base metal	121 198.9	0.8
Machinery, electrical technological equipment	29 599.5	0.2
Vehicles other than railway or tramway rolling stock, ships and air-transport facilities	171 387.7	1.2
Musical instruments, medical and other equipment	5 292.4	0
Miscellaneous manufactured articles	6 745.1	0
Works of art, collection pieces and antiques	445.3	0

Source: The State Statistical Committee of Azerbaijan Republic.

Imports

Imports of consumer goods accounted for USD 2.6 billion with USD 826.7 million as the share of foodstuffs. Machinery-equipment accounts for 11.9% (USD 773.3 million) and is partly a result of foreign investments. Intermediate products, such as machinery, chemicals, ferrous and non-ferrous metals, were imported for further manufacture, and were worth USD 3.2 billion.

Table 2.12. Share of main imports by category in total imports, 2009

Classification	Imports (USD thousand)	Share (%)
Total	6 119 724.7	100
<i>Of which:</i>		
Live animals	65 725.0	1.1
Vegetables and plant materials	313 819.2	5.1
Animal and vegetable fats and oils and related products	72 446.6	1.2
Food products, beverages, spirits and vinegar, tobacco	519 606.2	8.5
Mineral products	171 947.9	2.8
Products of chemical industry	401 747.8	6.6
Plastic, rubber and articles thereof	169 624.6	2.8
Rawhides and leather articles	3 070.4	0.1
Wood and articles of wood	86 503.1	1.4
Paper and paperboard	128 862.1	2.1
Textiles	53 180.1	0.9
Footwear, headwear	8 095.3	0.1
Articles of stone, cement and ceramic	156 357.6	2.6
Pearls, precious stones, precious metals	21 132.1	0.3
Miscellaneous articles of base metal	663 282.6	10.8
Machinery, electrical technological equipment	2 128 996.5	34.8
Vehicles other than railway or tramway rolling stock, ships and air-transport facilities	780 801.6	12.8
Musical instruments, medical and other equipment	213 439.4	3.5
Miscellaneous manufactured articles	68 493.5	1.1
Works of art, collection pieces and antiques	11 998.5	0.2

Source: The State Statistical Committee.

Balance of payments

Overall, the balance of payments surplus increased by 4.2 times, from USD 2.9 billion (8.8% of GDP) in 2007 to USD 12 billion (24.7% of GDP) in 2008, driven mainly by the current account surplus of USD 16.5 billion. In 2008, crude oil exports increased by 2 million tonnes at average prices per barrel rising from USD 72.9 to USD 96.5, resulting in crude oil export gains of USD 26.3 billion (an increase of 1.4% yoy), while total oil commodities exports accounted for USD 29.1 billion. AIOC's share in total crude oil exports was worth USD 24.2 billion with USD 14.7 billion and USD 9.5 billion for Azerbaijan's share and to Contract of the Century's foreign participants respectively. The foreign trade balance increased by 1.5 times in 2008, amounting to USD 23 billion. Oil and oil-related goods' share in total exports was 93.1% in 2008. Non-oil exports accounted for USD 1.4 billion (33.7% increase over 2007) driven by chemical goods and ferrous and non-ferrous goods. The capital and financial account, which had a negative balance of USD 3.6 billion in 2008, was, however, covered by the current account, which doubled in 2009 to USD 6.1 billion before decreasing by a third in

Q1-Q3 2010, to USD 2.6 billion. The positive balance in the oil-gas sector provided the foreign currency demands of the economy and increased reserves inflows to USD 8.3 billion in Q1-Q3 2010.

Consumer goods imports increased by 19.1% between 2007 and 2008 amounting to USD 3 billion, with a 34.5% increase for food products.

Table 2.13. Balance of payments

(USD million)

Balance of payments	2006	2007	2008	2009	Q1-Q3 2010
Current account	3 708	9 019	16 454	10 173	11 977
Goods and services (balance)	5 822	13 093	20 669	12 970	14 266
Goods (balance)	7 745	15 224	23 012	14 583	15 418
Services (balance)	-1 923	-2 131	-2 343	-1 613	-1 152
Income (balance)	-2 681	-5 079	-5 266	-3 519	-2 685
Current transfers (balance)	566	1 005	1 050	722	397
Capital and financial account	-1 735	-5 760	-3 558	-6 019	-2 618
Capital account	-4	-3	11	9	-
Financial account	-1 732	-5 757	-3 569	-6 028	-
Direct investment	-1 306	-5 103	-545	146	326
Portfolio investment	-12	-26	-347	-139	2 944*
Other investment	-430	-696	-2 680	-6 036	-
Reserves assets	-1 716	-2 898	-12 050	-2 691	-8 305
Net errors and omissions	-256	-361	-846	-1 463	-1 054

Note: *including portfolio and other investment.

Source: The Central Bank of Azerbaijan Republic.

The non-oil sector deficit of USD 4.7 billion was covered by a USD 19.3 billion surplus in the oil-gas sector. The current account surplus almost tripled from USD 3.7 billion to USD 10.2 billion in three years, between 2006 and 2009, and totalled USD 11.9 billion in Q1-Q3 2010.

Total services increased from USD 3.3 billion in 2005 to USD 5.2 billion in 2009, with negative balance averaging USD 2 billion over the same period. However, this negative balance's correlation to GDP decreased from 15.7% to 4.6% between 2005 and 2009, thanks to the growth of nominal GDP. The negative balance of services has been related to activities in the country's oil and gas sectors. The lion's share in services belongs to construction and transport. Construction is related to international agreements in the oil and gas sector, while transport largely reflects transit cargo transportation between Central Asia and Europe within the network of TRACECA (Transport Corridor Europe-Caucasus-Asia). The share of transport in total services averaged 26% between 2005 and 2009 increasing from USD 0.4 billion to USD 0.8 billion and from USD 0.2 billion to USD 0.7 billion, respectively. Tourism receipts accounted for USD 0.35 billion in 2009 increasing 4.5 times over USD 0.08 billion in 2005. Business-trip receipts accounted for 44% of total receipts in 2009. Services provided to Azerbaijani tourists also grew from USD 0.16 million in 2005 to USD 0.38 billion in 2009.

Table 2.14. Main services
BoP data (USD thousand)

	2008			2009			H1 2010		
	Inflow	Outflow	Balance	Inflow	Outflow	Balance	Inflow	Outflow	Balance
Balances on services	1 546 904	3 889 464	-2 342 560	1 776 287	3 388 930	-1 612 643	918 417	1 694 239	-775 822
Transport	793 929	682 511	111 418	662 060	801 436	-139 376	293 336	375 809	-82 473
Tourism	190 247	341 103	-150 856	352 805	380 114	-27 309	242 974	310 927	-67 953
Communication	46 929	27 986	18 943	71 971	46 451	25 520	33 623	27 452	6 171
Construction	109 104	1 440 757	-1 331 653	174 289	773 739	-599 450	95 306	187 962	-92 656
Financial	117	12 511	-12 394	286	15 384	-15 098	231	3 506	-3 275
Governmental	92 898	63 358	29 540	80 470	60 764	19 706	42137	29 287	12 850
Other services	313 680	1 321 238	-1 007 558	434 406	1 311 042	-876 636	210 810	759 296	-548 486

Source: The Central Bank of Azerbaijan Republic.

MILLENNIUM DEVELOPMENT GOALS

In 2000, Azerbaijan agreed to the MDGs to achieve poverty reduction and promote human development. Initial discussion of country goals and approach had taken place in the principal policy document, the Azerbaijan Poverty Reduction Strategy Paper and the State Programme on Poverty Reduction and Economic Development 2003-05 (SPPRED). The SPPRED, on the development of the principal strategic directions and goals over 2003-05, liberalised the investment environment and stimulated large inflows. The subsequent State Program on Poverty Reduction and Sustainable Development 2008-15 (SPPRS) has been closely aligned with the MDGs and strategically aimed at enhancing the quality of and ensuring equal access to basic health and education services.

The Azerbaijan National Coalition on Global Call to Action against Poverty expects Azerbaijan to achieve most of the MDGs in 2015, as the country benefits from growth of its economic potential, but also from speeding up existing reforms in education, health and other fields.

The country's development has been slowed by the unresolved issue of the Nagorno-Karabakh region, which has led to around 700 000 internally displaced people in Azerbaijan and some 300 000 refugees. On the other hand, in order to improve the social environment, and with the assistance of the International Development Association (IDA), the government has established a poverty-reduction strategy as well as an implementation of significant reforms in social sectors and infrastructure.

Basic indicators

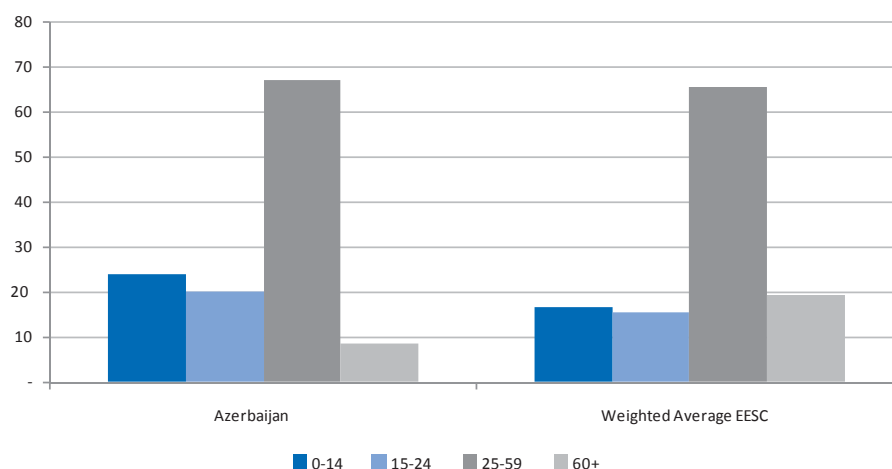
As of January 2010, the population was 9 million; an increase of 1.05 million people compared to 1999. Some 54% of the population lives in urban zones and the remainder in rural areas. The birth rate has decreased, compared to Soviet times. According to the State Statistical Committee of the Republic of Azerbaijan, the number of abortions increased from 20 867 in 2006 to 25 256 in 2008.¹⁹ The State Statistical Committee stated that between 2003 and 2006 the birth rate in Azerbaijan rose by 31%, while according to a 2006 UNICEF²⁰ survey, the fertility rate of 20-24 year olds decreased by 23.36%, to 1.64 children per woman from 2.14, over the same period. Another important figure is the fertility rate of 25-29 year olds which collapsed by 45% (to 1.08 children per woman in 2006 compared to 1.97 in 2003).

Table 2.15. Age-Population distribution comparison

Age category	0-14	15-24	25-59	60+
Percentage of total population (in 2010)	23.9	20.2	67.4	8.7

Source: WB WDI, 2010.

Figure 2.7. Age-population distribution comparison



Source: World Bank 2009a.

The share of youth in Azerbaijan, both in the 0-14 and the 15-24 age ranges, is higher than the average of the EESC countries – the opposite being also true for the 60+ range – indicating the preponderance of this age group in the country. Moreover, the median age in Azerbaijan was 28.2 years old in 2009, against an average of 33.5 in the EESC countries.

According to the State Statistical Committee, life expectancy rose from 71.8 in 2000 to 73.5 in 2009. Females' life expectancy was 76.1 years, while males' was 70.9. However, according to the CIA, life expectancy of the total population of the country is only 66.7.

There were some amendments and additions in late 2009 to the Law "About labour pensions", which are worth mentioning. According to the former legislative base, men who have reached 62 years, and women 57, both having at least 12 years of work experience, could retire. According to the amendments to the Law, the pension age will increase by six months every year, from January 2010 until January 2016, to reach 63 and 60 respectively for men and women.

Goal 1: Reduce poverty

Target: Achieve full and productive employment and decent work for all

According to the International Labour Organization (ILO), the total of unemployed²¹ people decreased by 143 300, from 404 700 in 2003 to 261 400 in 2008, while the total active population increased by 516 000, from 3 801 400 (46% of the total population) to 4 317 400 (49.5%) over the same period. Youth unemployment, covering 15-24 year olds, also decreased by 72 500, from 165 600 to 93 100 between 2003 and 2008. According to the World Bank, there was a small contraction of the labour force between 2000 and 2008. The country also hosted about 15 000 immigrants employed primarily in the construction sector until the crisis. On the other hand, remittances increased ten-fold between 2000 and 2008, reaching approximately USD 1.2 billion.

Table 2.16. Employment evolution
(percentage)

	2006	2009
Unemployment	6.8	6.0
Youth employment*	40.7	34.5

Note: *15-24 years old.

Sources: The State Statistical Committee of Azerbaijan Republic (Similar figures provided by the ILO).

Target: Eradicate extreme poverty and hunger

Objectives: Reduce by 2015 the proportion of people whose per capita monthly consumption expenditure is below the country's absolute poverty line, and the proportion of people in extreme poverty. Halve the share of the population below the relative poverty line of the country.

There is a disconcerting lack of data concerning poverty indices in Azerbaijan; missing data are compounded by outdated material. Any analysis, therefore, including our own, must be treated with caution. Following the government's economic development programme, poverty is on a downward trend.

The lowest 10% and the highest 10% of the population hold, respectively, about 6% and 18% of total revenues in Azerbaijan.

Table 2.17. Poverty indicators

	2001	2005
Poverty gap at USD 2 a day PPP (%)	6.8	0.5
Poverty headcount ratio at USD 2 a day PPP (% population)	27.1	2

Source: WDI 2010.

The poverty level decreased from 49% to 11.2% between 2001 and 2009. According to the World Bank,²² some 2.5 million people in Azerbaijan have moved out of poverty in recent years. Overall, the poverty rate has dropped by 3% annually between 2001 and 2008. Thanks to the rapid economic growth and social assistance programme launched in 2006, some good results have been obtained, even compared to developed countries. Azerbaijan has a better chance to achieve this MDG by 2015 than most other CIS countries by distributing oil revenues more equitably, developing the non-oil sector prudently and improving the investment and business environment.

Poverty is higher in rural areas (51.2% of the poor) than in the towns (48.8%).²³ About 30-35% of the rural population live below the poverty line and about 10% of these live in extreme poverty. Rural communities have major problems in education, health and utilities. The government's social aid programme has been in place since mid-2006 and targets the poorest of the population whose monthly income is below AZN 65 (USD 80.9). The government estimates that the number of families receiving this help should reach 150 000, with the poverty line set at AZN 110 (USD 137). AZN 210 million (USD 261.5 million) was allocated in the state budget for the purposes of this social assistance.

Poverty overall, particularly in the capital, would appear to be rapidly decreasing. One reason for this has been the six-fold increase in wages and labour fees since 2001 and the increase in volume of incomes transferred to the poor – in 2004, 20% of the poor households benefited from a 35% increase in government aid. Pensions also increased by 44%, while households have largely benefited from transfers from their relatives working abroad.

However, according to a study published by the Economic Research Center (ERC, 2010), an Azerbaijani non-profit research centre, official data on poverty understate the problem and the real figures are higher than those announced. Indeed, the ERC shows that the cost of the minimum consumption basket is AZN 119, higher by 41% than the official basket of AZN 84.

Goal 2: Achieve near-to-universal secondary education

Target: Complete full primary education

One of the greatest legacies that Azerbaijan inherited from the Soviet era is a strong educational system. Enrolment rates in basic education are close to 100%, although the poor have higher dropout rates. There are 4 533 government-supported schools and 17 private schools. The number of state institutions of higher education was increased to 34 in 2009 from 29 in 2000, while private institutions decreased from 18 to 14 over the same period. General education schools cover 11 years of compulsory education where almost all fees are covered by the government.

Education has been kept under state control, receiving around 3% of GDP, of which approximately 85% goes to wages. Thus, only 15% of funds are directed to equipment and technology purchases.

The problems of this sector lie in the quality of education in the context of a need for skills and knowledge to overcome the skill gap accentuated by globalisation. More attention needs to be given to the improvement of the quality of education and its outcomes in order to achieve this MDG.

According to official statistics, however, only 108 000 pupils received high school diplomas in 2009, compared to 173 000 in 1998. Besides, 23 000 school-leavers failed to graduate. Thus only 60% of school students finish general school. In general, one out of ten school-leavers is able to go to university on the basis of educational attainment.

According to a World Bank report, there are low enrolment rates in higher education and serious inequalities in pre-school and tertiary education (World Bank, 2010c). Inadequate levels of education

substantially restrain the development of the country. A major problem is the poor condition of education infrastructures and the quality of the personnel. There is also a problem of incentives, since education does not seem to provide significant economic advantages. Only 17% of the population opts for higher education, compared to 50% in developed countries.

Table 2.18. Main education data

	2000	2009
Number of children in pre-school institutions	111 020	103 617
Number of pupils in general schools	1 653 703	1 428 859
Of which: female (%)	48	47
Number of teachers in general schools	161 492	174 378
Of which: female (%)	69	73
Number of pupils in vocational schools and vocational lyceums	22 944	25 184
Of which: female (%)	37	30
Number of students admitted to secondary education	14 823	15 681
Number of students in specialised secondary educational institutions	42 612	52 759
Of which: female (%)	69	69
Number of students of specialised secondary educational institutions per 10 000	55	63
Number of graduates of specialised secondary educational institutions per 10 000	15	21
Number of students in higher educational institutions	119 683	136 587
Of which: female (%)	15	46
Number of students in higher educational institutions per 10 000 people	154	162
Number of graduates of higher educational institutions	24 488	32 580
Number of graduates of higher education per 10 000 people	32	39

Source: The Statistical Committee of Azerbaijan Republic.

Goal 3: Ensure gender equality

Gender norms have changed since the end of the Soviet regime. Formerly, both women and men achieved high levels of education and had broad work experience in the Azerbaijan economy and government. However, today women are more likely to be under-employed or unemployed than men and to receive lower relative wages. Women engage in informal work such as part-time, temporary or home-based jobs in order to take care of their families. Women also lag far behind in business ownership, except at the micro level. Women are mostly to be found in lower and line management, except in female-dominated, lower-paid sectors such as education, health care and natural sciences, and in agriculture where the average monthly salary is lower than the national average.

Women make up 51% of the population. Their poverty level is higher and half of them live below the poverty line. Of the officially registered total number of unemployed persons, 47% were women in 2008. Few women are represented in the highest levels of power. The main reasons for this are lack of interest, time and understanding of what leadership means, as well as a cultural issue, as women are convinced that a leader has to be a man. As a result, only 11.2% of parliamentary seats are held by women in Azerbaijan.

There is no significant gender difference in enrolment rates at the primary level, but disparities at the secondary level, especially in rural areas, are a concern. There is a need to encourage more women into tertiary education and expand their choices in educational specialisation. However, the labour market needs to provide women with opportunities to use their skills.

The State Committee on Women's Issues was established in 1998, and gender issues have been shown to be a part of the democratisation of the country. Hence, it has become a priority to involve larger numbers of women in the decision-making process. Success in achieving this goal requires a long-term strategy on changing public opinion and overcoming traditional stereotypes by focusing on educational programmes. On the legal level, the government adopted the Law on Gender Equality in 2006 and in 2000 the President issued a Decree on the State Women's Policy in the Republic of Azerbaijan.

Health issues

Main indicators

Azerbaijan has yet to achieve significant improvement in maternal medical care. The years 2008-13 are decisive in achieving this goal. According to the SPPRSD, Azerbaijan should decrease under-1 and maternal mortality rates to the average of the European countries. Funds allocated from the state budget for health were increased by more than 9.8 times between 2000 and 2009, but this is still less than 1% of total GDP. Health spending per capita was USD 56 in 2009, far from the USD 150 recommended by the World Health Organization (WHO).

Table 2.19. Major causes of death

Category (per 100 000)	2000			2005			2008		
	Total	Urban	Rural	Total	Urban	Rural	Total	Urban	Rural
Total deaths by major cause	589.0	583.3	595.0	628.2	641.2	614.3	615.8	627.4	603.9
Diseases of the circulatory system	330.5	354.7	305.4	355.3	374.9	334.5	363.6	371.0	355.7
Disease of the respiratory system	53.1	28.4	78.6	37.1	23.9	51.2	33.3	22.9	44.5
Neoplasm	64.1	66.1	62.0	77.2	84.1	69.7	76.1	84.3	67.3
Injuries, poisoning, external reasons	26.4	30.0	22.8	32.6	37.1	27.8	28.6	31.1	25.9

Source: The Statistical Committee of Azerbaijan Republic.

Goals 4 and 5: Reduce maternal mortality and mortality rate under-5 by 17% each

According to UNICEF, under-5 mortality in Azerbaijan in 2007 was 39 per 100 000, ranking 77th among 194 countries. This mortality mainly occurs due to poor access to medical care, poorly qualified and motivated doctors, women's non-attendance at maternity welfare centres, incompetent and untimely medical care and home-based birth. According to the State Statistical Committee, the maternal death rate fell from 37.6 (per 100 000 live births) in 2000 to 24.3 in 2009, with the lowest rate of 18.5 in 2003 and the highest of 35.5 in 2007, revealing high volatility. There is some inconsistency between UNICEF and official figures as for 2007 the latter estimated 12 child deaths out of 100 000 births, while the former recorded 34. The figures for 2006 show that infant and under-five mortality rates have been reduced to half since 2001, but this is still considerably higher than in the developed countries. The major causes of child death in Azerbaijan are respiratory diseases and diarrhoea.

Infant mortality also increased in 2005, 2006 and 2007, to 1 580 per 100 000 live births (12.7%), 1 882 (11.9%) and 1 756 (12.1%) respectively. Although there have been some reforms, a strategy reducing child and maternal mortality rates has not been established. Moreover, declining marriage, low use of contraception, extra-marital birth and the spread of abortion will add to the problems in achieving this goal.

Goal 6: Combat HIV/AIDS, malaria and other diseases

Target: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS

Azerbaijan is a country with a low level of HIV (below 0.2%). Only 2 264 people were officially registered as HIV-positive in 2009. However there is a growth trend (in 2000 there were 64 infected people), particularly among high-risk groups, with a threat of rapid increase. Furthermore, this number may well be higher than the official data suggest. The overwhelming majority of the infected persons are men (around 85%) but growth in the number of HIV-infected women is also preoccupying. One-third of all HIV-infected patients are returning emigrants to Ukraine or Russia where the AIDS epidemic is expanding.

The law "About prevention of spreading of AIDS" was adopted in 1996 but does not meet requirements. A new law was being drafted by the parliament in 2010 and will cover issues such as international best practices, preventive measures, diagnostics, treatment and inspection, as well as the rights of HIV-infected people.

Tuberculosis

Tuberculosis is still a serious disease in Azerbaijan. The situation has become even more complicated with the arrival of multidrug-resistant forms of the disease. In 2001, there were 4 847 patients in the country and 5 130 in 2008 with a decreasing trend (in 2007, 6 530 persons were treated for tuberculosis in Azerbaijan). The 20-40 age group accounts for approximately 80% of the total patients and the situation is particularly bad in prisons. The level of awareness of the population about tuberculosis is very low.

Since 1995, the government has carried out programmes with the help of international organisations to fight tuberculosis. There have been improvements in health services, obtaining modern medical equipment and in statistical data, but rates of detection and treatment remain below the international standards. Complicating the picture are more than 1 million refugees and internally displaced persons (IDPs) and, though their living standards have been improving year by year, their health situation is still dire.

Main health reforms

Legislative attention to health matters became a priority from 1998, with the formation of the State Commission on Reforms in the field of public health services. A National plan on fighting diseases, such as AIDS and tuberculosis, was developed. As a result, in 1998, the WHO recommended a three-fold increase of aid to Azerbaijan. This is unusual since little, if any, external financing is usually for public health, which is generally financed by internal funds. Indeed, external resources as a percentage of total expenditure on health decreased from 3.9% (AZN 184 million) in 2000 to 0.7% (AZN 275 million) in 2008.

In 2003 the sum allocated by the government to health services increased from AZN 55.3 million to AZN 400 million in 2009. It is planned to increase this figure to AZN 600 million by 2013. Since 2008, medical institutions financed by the state have rendered free medical services to the population. In 2009, more than 60 medical institutions of vital importance in the country were constructed or completely overhauled.

Table 2.20. Main health expenditure

2008	Azerbaijan	OECD
Private health expenditure (in % GDP)	3.8*	3.0
Public health expenditure (in % GDP)	1.2	1.1
Out of pocket expenditure (% private expenditure)	80.4	86.4
Health spending per capita (USD)	56	102**

Notes: *2002, **2006

Source: WDI 2009.

There is little private-sector activity in health services and the majority are provided by the state. Medical institutions are divided between the Ministry of Health and local authorities. Private clinics, mostly located in the capital, are keen to reach western standards on the quality of services, but these are limited to small clinics. They are short of medical supplies and not many of them have advanced equipment. Since independence, almost all the pharmaceutical sector has been privatised, but it is still regulated by the Ministry of Health. The majority of chemists are private enterprises, with only a small number remaining under state ownership. The manufacture of medicines has also passed into private hands. Unfortunately, there are no updated data to assess the proportion of the population with access to private hospitals.

Goal 7: Ensure environmental sustainability

Target: Halve, by 2015, the proportion of people without sustainable access to safe drinking water

The introduction of new technologies has improved the environmental situation in the Caspian Sea to some extent – but many problems remain, particularly associated with old oil fields in the Absheron peninsula. Water supply and water quality are also of major concern, threatening both urban and rural communities. The river Kura, which is the main source of water for three-quarters of the population, is soiled by the population and by the industrial facilities of Armenia and Georgia, as well as Azerbaijan. Co-operation between the three countries regarding water-resource sharing has become an important issue.

According to recent analyses by the United Nations Country Team (UNCT) only half the population have drinking water directly piped into their houses, with a huge difference between urban and rural households (78% against 19%, respectively). However, almost all urban households (91%) and slightly more than half of rural households (55%) have access to clean drinking water outside their homes. A total of 78% of all households use improved sanitation facilities.

Target: Reduce pollution

Objective: Integrate the principles of sustainable development into country policies and programmes and reverse the loss of environmental resources.

Domestic waste and the absence of adequate transportation and disposal systems have negatively affected health and general living conditions, with intensive land use and the growth of slums on the outskirts of the capital.

By 2010, the quantity of greenhouse gas emissions in Azerbaijan considerably decreased, compared to 1990, since many sources of pollution (mostly enterprises) have stopped working following the collapse of the USSR. However, air pollution is expected to increase significantly with the recovery of the heavy industry in the Baku-Sumgayit area. Around 70 million tonnes of carbon was emitted in 1990 against 46 million tonnes in 2005. However, transport's contribution of air pollutants also increased from 43% in 2000 to 70% in 2009, which is related to the more than doubling of the number of automobiles over the same period. Its share is especially high in the capital.

Yet, Azerbaijan has joined the Kyoto protocol and has therefore been preparing the national strategy for fighting global warming. The government is working on the development of alternative energy sources. Solar energy in Azerbaijan, which has more than 250 days of sunshine per year, is also promising. The year 2010 was proclaimed as the Year of Ecology in Azerbaijan.

Table 2.21. Environmental data
(thousand tonnes)

Emission of air pollutants from mobile sources by ingredients		
	2000	2009
Carbon oxides	148.2	496.3
Nitrogen oxides	31.3	58.6
Hydrocarbons	56.4	95.5
Specific pollutants	156.8	46.7
Total	392.7	697.1
In Baku (%)	58.5	68.0
Air pollutant emissions from stationary sources by ingredients		
Gaseous and liquid matters	496.2	280.2
sulfuric anhydride (SO ₂)	35.1	4.3
carbon oxides (CO)	26.3	27.6
nitrogen oxides (NO ₂)	24.2	24.2
Total	515.4	300.0

Source: The Statistical Committee of Azerbaijan Republic.

PRIVATE SECTOR DEVELOPMENT

The impact of the financial crisis on Azerbaijan was less severe than in other countries of Eastern Europe and the South Caucasus (EESC). High GDP growth (9.3%) in 2009 (IMF, 2010) was directly linked to the contribution of the oil sector, thanks to increasing oil exports and higher global oil prices. According to IMF forecasts, GDP growth in 2010 and 2011 is expected to slow down to 2.7% and 0.6% respectively. For a return to former growth rates, Azerbaijan will need to enhance the competitiveness of its economy which calls for policies that stimulate private-sector development and foster diversification, especially outside the energy sector.

The private sector is a source of knowledge, skills and resources, and a key engine of growth for industrial development. In this context, the role played by micro, small and medium-sized enterprises (SMEs), which, on average, account for over 90% of enterprises in the world and contribute to 50%-60% of employment in developing countries, is particularly important (WBSCD, 2007). Efforts to foster private sector growth could focus on improving the business environment for SMEs by providing a regulatory framework conducive to entrepreneurship through better policy design including improving business regulation, strengthening the education system and providing access to finance for SMEs that would encourage the entry of new firms as well as increase the share of employment and contribution to GDP in the private sector.

The methodology applied in this section is based on the OECD Policies for Competitiveness Framework (PFC) which has been developed as an assessment tool based on the Policy Framework for Investment (PFI) instrument. This tool follows a horizontal approach, looking systematically at key policy dimensions affecting the business climate to identify and analyse key constraints in the ability of firms to produce, invest and grow. Apart from giving a general introduction to the business environment, three key dimensions are featured in this section covering skills development, access to finance and investment framework conditions affecting SME growth.

General overview

During eight years of small- and large-scale privatisation, 30 000 small enterprises were transferred into private ownership and 1 500 medium and large enterprises were transformed into joint-stock companies. Nevertheless, the presence of monopolies in various sectors of the economy continues to create barriers to entry and obstructs the creation of a level playing field within the private sector. In Azerbaijan, the private sector accounts for 75% of GDP (EBRD, 2010) and is dominated by small enterprises (6.8%) and individual entrepreneurs (92.6%). These figures do not take into account the large informal economy estimated at 52% of GDP (Schneider, 2010), one of the highest in the EESC region. It should be noted, however, that official figures for informality are much lower.

In 2009, Azerbaijan was one of the top reformers in simplifying business regulations according to the World Bank's *Doing Business* report (World Bank 2009b). The country made significant progress in improving the overall business environment for entrepreneurial activities, including start-up costs and time to start a business. Nevertheless, the SME sector in Azerbaijan is still highly dependent on the prosperous oil industry which, together with other sectors related to extractive industries, accounted for 67.1% of GDP in 2008. Moreover, the services sector (catering, hotels and wholesale trade) is thriving as a result of oil-sector spillovers, and hence is not sustainable in the long term. The government should work towards diversification of the economy and decrease the country's dependence on the oil sector, not least since oil production is expected to start slowing down in 2015 (Rabobank, 2009).

Specific challenges to competitiveness and private-sector development include the need to upgrade the education system as the lack of an adequate labour force is one of the key constraints to business growth. More emphasis needs to be put on the development of vocational education as well as continuing education and training on the job to ensure that labour-market needs are met. In 2007, Azerbaijan spent 1.7% of GDP (World Bank 2010a) on education which is less than in any other EESC country. Low levels of spending can have a negative impact on the quality of education through the loss of qualified teaching staff.

Access to finance remains another key hurdle, especially for SMEs operating in non-oil sectors. In 2009, domestic credit to the private sector reached only 24.3% of GDP (EBRD, 2010), among the lowest values in the region. The largest share of credit is concentrated in the energy sector or related areas while the rest of the economy remains underfinanced. Moreover, the large exporting energy industry leads to a strong national currency which makes other sectors of the economy less competitive in external markets.

FDI inflows are mainly concentrated in the energy, transportation and communication sectors. A comprehensive investment promotion strategy should thus focus on diversification of inflows of foreign direct investment to support the development of productive industries in other parts of the economy. To better attract foreign investors, Azerbaijan will have to further liberalise its investment policy framework and ensure higher transparency in registration and licensing procedures.

The increasing role of the private sector

Currently, the private sector represents 75% (EBRD, 2010) of GDP and employs about 63.6% which is lower than in most countries of the region. In 2007, only 4 945 new micro, small and medium enterprises registered a new business, fewer than in 2005, and at a lower rate (7.13%) compared to the business entry rate of the Europe and Central Asia (ECA) region (10.10%) (State Statistical Committee of the Republic of Azerbaijan, 2010).

The SME sector mainly consists of individual entrepreneurs (sole owners who do not form a legal entity) and small and medium enterprises (legal entities) that fall under the "small business units" definition.²⁴ The definition of a "small business unit" was set by the Cabinet Council of the Azerbaijan Republic on Criteria for Defining Small and Medium Enterprises Based on the Economic Activity #57 in 2004. Small enterprises are defined based on the number of employees and turnover. In construction and industry, a firm is small if it has fewer than 40 employees and an annual turnover of less than AZN 200 000 (USD 247 000). In agriculture a small firm has fewer than 15 employees and a turnover of less than AZN 100 000 (USD 123 500). The wholesale trade figures are 10 employees and a turnover of less than AZN 300 000 (USD 370 500). In other sectors the number of employees should be fewer than 5 and the turnover less than AZN 100 000 (USD 123 500).

According to the 2008 *Statistical Yearbook of Azerbaijan*, 13 465 small enterprises and 195 732 individual entrepreneurs were registered in 2007,²⁵ which represent 6.8% and 92.6% of the total registered business population respectively. At the same time, if individual entrepreneurs are excluded, small enterprises represent 92% of the total number of enterprises and account for 61.5% of employment. The high share in the business population and employment is due to the very concentrated oil sector, which contributed to only 1.1% of employment in 2008. According to an International Finance Corporation (IFC) study of the SME sector in Azerbaijan, individual entrepreneurs account for approximately 90% of the SME sector employment.²⁶ Due to the extensive oil production in Azerbaijan (52.7% of GDP in 2008), which is dominated by large enterprises, SMEs' share in GDP is relatively low. According to the IFC, SMEs contributed to only 15% of GDP growth in 2006 (IFC, 2009). On the other hand, in 2007, retail and wholesale trade, a low value-added sector that contributed to only 5% of GDP (7% in 2009), was the main area of activity for 45% of small enterprises and 66.6% of individual entrepreneurs.

It is important to note that the informal sector is relatively large which is why any statistics on private sector size and contribution to GDP need to be regarded with care. According to BEEPS 2009, only 85% of firms were registered when starting operations (EBRD/World Bank, 2009). Therefore, the estimates for the number and share of employment of the SME sector are likely to be underestimated.

The presence of an extensive and prosperous oil sector affects the economy and small businesses in particular. The strong position of the gas and oil industry also underlined impressive growth rates in the non-oil sector (15.7% in 2008), even more than in the oil sector. On the other hand, the excessive dependence on oil and gas products makes the economy particularly sensitive to price shocks within the oil industry, and represents a risk for non-oil-related manufacturing through increases in the real exchange rate. The capital-intensive oil sector also means that income generation is concentrated in this sector and distribution is uneven. Moreover, many small enterprises related to the oil sector depend on large firms, rather than on internal competitive advantages.

Business environment

Azerbaijan has made significant progress in improving the business environment for entrepreneurs and small businesses. In 2009, it was one of the leading reformers of business environment regulations (World Bank, 2008). In 2011, the country ranked 54th and 15th, among 183 countries, for ease of doing business and starting a business, respectively (World Bank 2010b). Since 2003, the start-up cost has decreased from 16.8% to 3.1% of gross national income (GNI), while the time required to start a business was reduced from 105 to 8 days.

Nevertheless, the business environment in the non-oil and gas sectors clearly requires implementation of additional market-oriented reforms. There are still many constraints on the business environment that limit the development and growth of private enterprises, especially those operating in the non-oil sector. The complex tax and customs system and bureaucratic delays in issuing licences and permits continue to pose major constraints to private enterprises, particularly those of small size. Corruption is also a key obstacle to enterprise growth. Azerbaijan ranks 134th among 178 countries in the Transparency International Corruption Perceptions Index 2010. According to BEEPS 2009, 43.24% of entrepreneurs report they have been expected to give gifts in meetings with tax officials, while the regional average for EESC countries is at 12.9%.

The business-operating environment has to be further improved by taking appropriate measures which will have a positive impact on employment and economic growth. The volume, the quality and the targeting of social services geared to poverty reduction has to be improved. Considerable efforts have to be made in order to raise the education level, especially concerning secondary and higher education. Finally, yet importantly, the ecological balance and environmental sustainability have to be seriously taken into consideration. It is worthwhile to note that 2010 was declared as the Year of Ecology in Azerbaijan.

The government is implementing programmes to support SMEs and create a level playing field for all businesses. As part of the State Programme on Socio-Economic Development for 2009–13, Azerbaijan took measures to promote the development of entrepreneurship (including SMEs) and sustainable business development. In October 2009, President Aliyev signed into law the Statute and Rules of use of the National Fund for Entrepreneurial Support, which is managed by the Ministry of Economic Development. Nonetheless public-private sector co-operation is still limited in Azerbaijan.

Several institutions have been created that focus on improving the business climate and increasing the government's support to SMEs. The Entrepreneurship Council, composed of local and foreign entrepreneurs, was set up under the President of Azerbaijan in 2002 to conduct periodic studies of current problems, provide corrective measures and help improve the business climate. The National Fund for the Support of Entrepreneurship, established under the Ministry of Economic Development in 2002, supports state economic policy and develops entrepreneurship in the non-oil sector. The Azerbaijan Investment Company, established in 2006, aims at regulating state policy to support entrepreneurial development and ensure an attractive environment for investment in Azerbaijan. The Azerbaijani Export and Investment Promotion Foundation (AZPROMO) is a joint public-private initiative established by the Government of Azerbaijan in 2003. The organisation is empowered to play a key role in public-private dialogue, serving as a bridge between investors, local producers and the government.

Specific policy challenges for Azerbaijan include skills development, access to finance and the investment framework for SME growth. These three areas have been identified as key to create better conditions for private sector development, competitiveness and investment. The OECD conducted a policy assessment based on government self-evaluation and feedback from private sector representatives. This assessment aims to gauge the current policy environment and identify areas for reform.

Human capital development

Strengthening skills development has been identified as one of the key contributors to competitiveness. The positive correlation between human capital and productivity has become increasingly important in the globalised world. Razzak and Timmins (2008) report a strong positive relation between the increase of university-qualified workers and the levels of labour productivity as measured by GDP per person. It is believed that natural resources, cost competition and strategic alliances do not alone suffice for achieving sustainable development (Memon *et al.*, 2009).

Enhancing competitiveness in Azerbaijan will require a higher commitment to invest in human capital as well as introduce reforms which will ensure that the educational system produces skills that match the demand of the labour market and further support private sector development. Five areas have been selected for an in-depth evaluation of the education system including:

- Strategy formulation
- Inputs to initial education
- Vocational education and training (VET)
- Continuing education and training (CET)
- Human capital outcomes

Two areas have been identified as being particularly important to support business development and need further reforms: the underdeveloped VET/CET systems and the lack of private-public dialogue in policy formulation and implementation.

The low quality of the educational system creates significant barriers for business development. Under the Soviet regime, the educational system in Azerbaijan was centralised, but the Law on Education of 1992 introduced a decentralised model and gave more autonomy to university-level institutions. During the transition years, the quality of the educational system deteriorated, due to insufficient funding and an outdated curriculum. The quality of the educational system now ranks 104th out of 139 according to the World Economic Forum Global Competitiveness Report 2010. In the 2009 Programme for International Student Assessment (*PISA*), Azerbaijan ranked 74th out of 75 countries, coming only above Kyrgyzstan. In *PISA* 2006, Azerbaijan scored 55th out of 57 countries in both reading and science. In mathematics it scored much higher, but still below the OECD average.²⁷

Expenditure on education decreased from 23.47% of total government expenditures in 1990 to 12.63% in 2007. The lack of funds is reflected in shortages of learning materials, equipment and low salaries for teaching staff.

The OECD assessment showed that the main problems within the educational system are related to underdeveloped VET and CET systems. In 2005, Azerbaijan approved a National Employment Strategy. Its main goal is the modernisation of the VET system, which was further consolidated in the

Concept for the Development of VET (2007-12). The VET system is historically the most underfunded sector. In 2007, government spending on VET constituted 1.8%-2% of GDP which covered wages and scholarships only (DVV International, 2008). In 2008, the spending increased to 2.2% of GDP.

Other objectives of the National Employment Strategy are to match the skills supply with demand, and to introduce a functional CET. There is insufficient co-operation between business and the government bodies that are responsible for drafting and approving the curricula. The skills and knowledge provided by higher educational structures do not correspond to labour market needs. A study on the link between education and employment (ETF, 2005) has shown that only 7.6% of the respondents were employed in a job that corresponded to their educational qualifications, for 3.5% it corresponded only partially, and for 17.6% it did not correspond at all. Projects on VET development tend to be initiated by employers rather than by the educational authorities. Following the employers' request, one VET school of tourism and hotel management has been established in Gabala and another one is being built in Ismayilli.

Several other projects that aim to modernise the VET curricula are under development: the "Vocational Education and Training Reform Strategy and Pilot Implementation in a selected region in Azerbaijan" with the technical support of the European Commission and the British Council; the "Azerbaijan Vocational Training Improvement Project" with UNESCO; and the building of the "Vocational Education Centre of High Technologies" with Dew International Company (Korea) that will train staff in information technology, car repair, electronics and engineering. The modernisation of the VET system so far is moving in the right direction, but, despite international support, it will require further financial commitments from the Azerbaijani government, for research of labour market requirements, materials and other needs.

Moreover, the government has to take stronger steps towards building a comprehensive system of continuing education and training. Given that Azerbaijan has an excess supply of general education graduates, private-public co-operation in the framework of CET/VET systems would allow the workers to improve their skills or change profiles according to labour market requirements.

Access to finance

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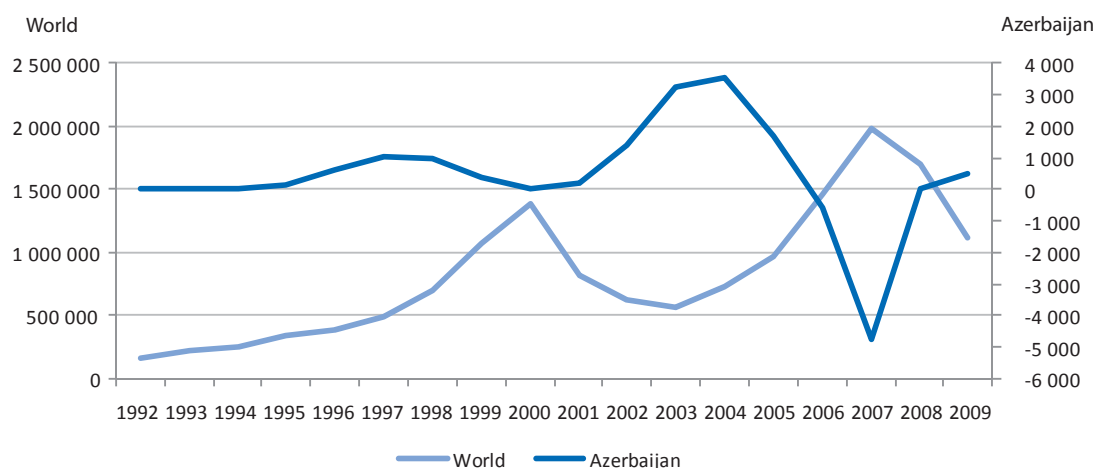
In 2008, domestic credit provided to the private sector was only 16.5% of GDP (EBRD, 2010), the lowest value in the region, and only 17.1% of it had been provided by the banking system. The banking market, even if rapidly developing (in 2010 there were 34 more financial institutions than in 2004, and one fewer national bank) and benefiting from no restrictions on currency transactions and capital flows, is still dominated by a state-owned bank that controls around half of total bank assets. Nevertheless, as shown by the rapidly increasing number of local branches of private banks and diminishing availability of branches of the state-owned bank, the sector is moving towards a more modern setting.

Access to finance has been reported by entrepreneurs in Azerbaijan as one of the key constraints. Despite having the lowest commercial loan refinancing rate and collateral requirement (102.43%) (IMF, 2010) in the region, only 19% of the companies use banks to finance their investment (EBRD/World Bank, 2009). Some 20% of firms have a line of credit or loan from financial institutions, which is a low share even compared to the regional averages of 37% and 35%. One of the main reasons is that most financial flows are concentrated in energy and energy-related sectors. To support economic diversification, the government should consider further developing innovative sources of financing such as micro-finance facilities and venture capital.

Investment framework for SME growth

Since 2002, Azerbaijan has attracted large investments in the oil and gas industry as well as in the construction and transportation sectors (the supporting sectors of oil and gas). However, net FDI inflows between 2002 and 2008 were below world average due to disinvestments in the oil sector in 2006 and 2007. The compound annual growth rate (CAGR) of investments for this period was thus only 3.2%,²⁸ compared to 14% for the world. Within the framework of Azerbaijan's diversification strategy, measures should be taken to attract FDI inflows to the underfinanced non-oil sector.

Figure 2.8. FDI net flows, 1992-2009
(Current USD million)



Source: UNCTADstat.

The legal regime for foreign investment in Azerbaijan was established by the 1992 Law on the Protection of Foreign Investment and the 1995 Law on Investment Activity. Foreign investors may invest in all sectors of the economy, except those related to national security. Investments in strategic sectors, such as energy and communications, are carefully controlled. By law, foreign investors enjoy non-discriminatory treatment and have the right to repatriate profits, revenues and other means legally earned in connection with an investment project.

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In 2003, AZPROMO was established as a joint public-private initiative to build balanced economic development and to implement measures necessary to attract investments that would create new jobs, particularly in rural regions, within the poverty-reduction strategy framework.

A law on special economic zones entered into force in June 2009, stipulating notably that special economic zone residents shall be subject to simplified tax of 0.5% payable from gross sales and non-sale revenues. Provisions concerning the procedures for the registration of residents in special economic zones and related certificates were adopted in December 2009.

As FDI inflows are mainly concentrated in the energy, transportation and communication sectors, Azerbaijan should focus on developing a comprehensive investment promotion strategy to strengthen the sector competitiveness of productive industries through diversification of FDI inflows. To better attract foreign investors, Azerbaijan will have to further liberalise its investment policy framework and ensure higher transparency in registration and licensing procedures.

NOTES

1. Potential reserves estimated at 6 billion barrels of oil.
2. Which includes Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine.
3. As a necessity to improve the profitability of public utilities (providing profitable tariff levels by overtaking cost price to attract private businesses to the sector) by reforms within the framework of the "Country partnership 2007-10" between the government and the World Bank.
4. Social protection, health, education, culture and arts, information, sport and other state social spending.
5. Informal economy refers to all legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: to avoid payment of income, value-added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal standards such as minimum wages, maximum hours, safety or health standards, etc. (OECD, 2002, p. 139). It does not concern illegal activities.
6. Including Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine (authors' calculation).
7. Laws "About bases of agrarian reforms", "About reforming of state farms and collective farms", "About land reform" and other major legislation accepted during 1995-96. Following acceptance of the Law "About land reform", the transfer of lands from state to private property began.
8. More programmes on BP's website: www.bp.com/genericarticle.do?categoryId=9029616&contentId=7059931
9. AIOC consists of British Petroleum, Chevron, SOCAR, INPEX, Statoil, ExxonMobil, TPAO, Devon Energy, Itochu, Delta Hess.
10. The largest national GSM-operator with more than 4 million users.
11. The largest GSM-operator Azercell Ltd. was privatised (remaining state shares privatised) in 2008.
12. Shareholders of BTC are: BP (30.1%); AzBTC (25%); Chevron (8.9%); StatoilHydro (8.71%); TPAO (6.53%); ENI (5%); Total (5%), Itochu (3.4%); INPEX (2.5%), ConocoPhillips (2.5%), and Hess (2.36%).
13. App. 5 million tonnes per year capacity; USD 600 million project; established in 1997.
14. 1.2 million b/d from 2009.
15. The leading bank in the country with about 45% of total assets in the national system, it is also the only state-owned bank yet to be privatised.
16. Prudential standards, which banks must implement.
17. According to the amendments put into force in mid-2009 in the Law "About the Central Bank of Azerbaijan Republic", the Central Bank may issue loans and subordinate loans to banks as well as real sector participants (through local banks) for a longer term and in various currencies.
18. The Central Bank injected AZN 1.8 billion into the domestic market during 2009 (5% of GDP).
19. However, real figures could be higher.
20. *Azerbaijan Demographic and Health Survey 2006*. Accessible at www.measuredhs.com/pubs/pdf/FR195/FR195.pdf.
21. Men aged 15 to 61 years; women aged 15 to 56 years.
22. April 2010, covered the period before the global crisis.
23. World Bank, figures for 2008.

24. The State Statistical Committee also provides data for “joint stock companies” and “stock exchanges”, but it is not clear whether these are the only categories used in the classification of enterprises.
25. The State Statistical Committee of Azerbaijan classifies “firm” as individual entrepreneurs, small enterprises, joint-stock companies and stock exchanges. This classification makes it rather difficult to make any comparisons and is not very clear from a methodological point of view.
26. Estimate based on the following formula: (Average number of employees per small enterprise – 2) x number IE = Total number of employees working for individual entrepreneurs.
27. UNICEF Country Profile, *Education in Azerbaijan*.
28. Severe disinvestment occurred in 2007, when net FDI inflows dropped and turned negative decreasing the stock of FDI of the previous year by 42.5%.

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